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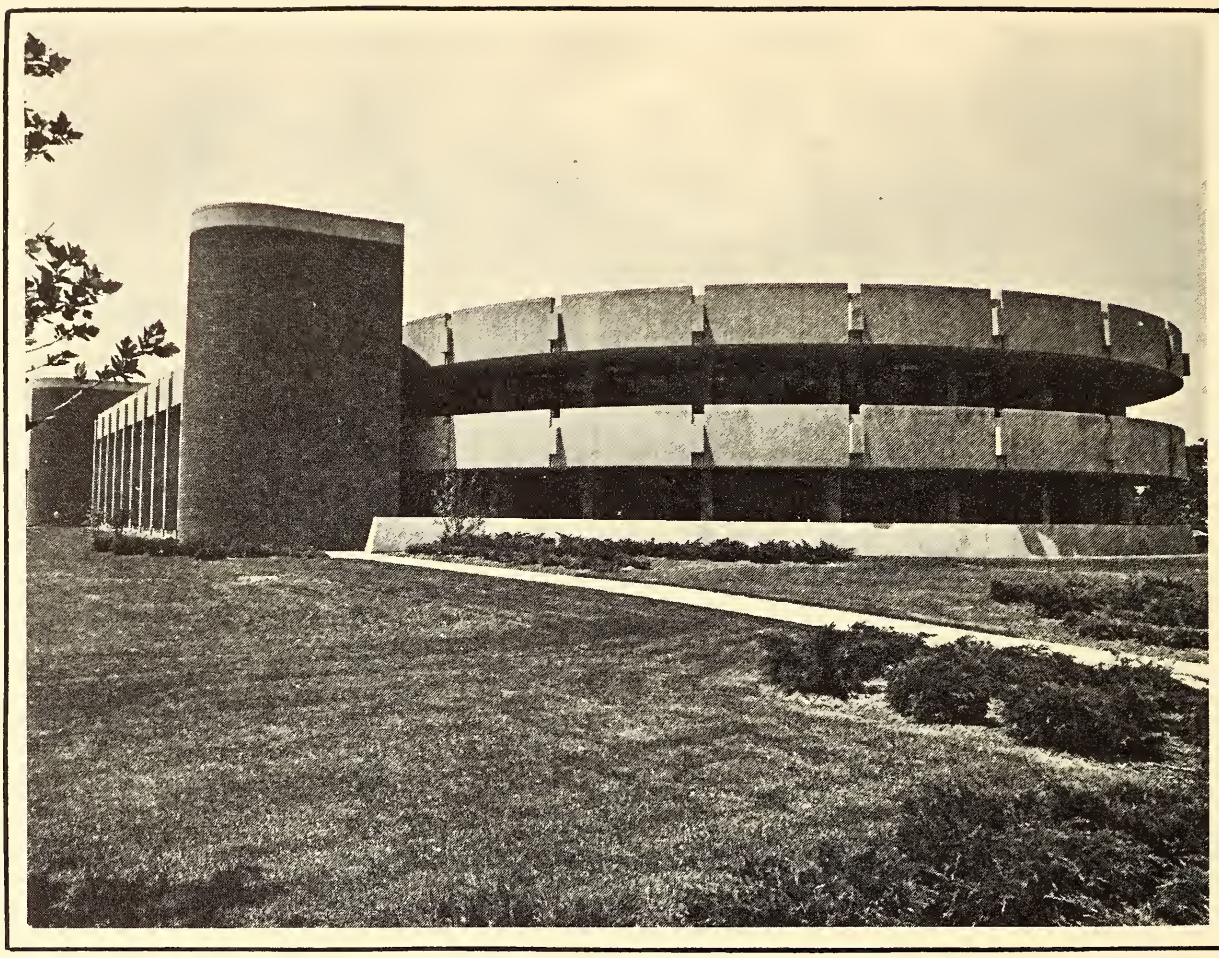

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An Essay: Six Competing Currents of Rule 10b-5 Jurisprudence

David M. Phillips*

Carpenter v. United States,[1] the recent decision in which the Supreme Court failed to accept or reject the application of the "misappropriation theory"[2] in rule 10b-5[3] cases, reportedly surprised many observers.[4] Winans, a reporter for the Wall Street Journal and one of the authors of its "Heard on the Street" column, tipped several confidants, including two Kidder Peabody brokers, as to the contents of future columns. Winans, Carpenter (Winans' lover), the brokers and a customer of the brokers were able to earn short-swing profits from the movement of

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*Professor, Northeastern University School of Law. This article is based on a paper delivered at the Seventh National Conference on Business Ethics, conducted at Bentley College on October 15-16, 1987. I would especially like to thank Virginia L. Symmes, class of 1988 at Northeastern University School of Law, for her research assistance and Barbara Aldave, Tamar Frankel, John Leubsdorf, and Roberta Romano for helpful comments on an earlier draft of the paper.

[1]108 S. Ct. 316 (1987).

[2]*See generally* Aldave, *Misappropriation: A General Theory of Liability for Trading on Non-Public Information*, 13 Hofstra L. Rev. 101 (1984).

[3]Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987), was promulgated by the Securities and Exchange Commission (the "SEC") under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). The rule states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

[4]*See, e.g.*, N.Y. Times, Nov. 17, 1987, at D10, col. 1; Wall St. J., Nov. 17, 1987, at 1, col. 6.

securities' prices following the appearance of the columns. The government brought a criminal action against Winans and several of these tippees, alleging both mail and telephone fraud and rule 10b-5 violations.

Supreme Court decisions applying rule 10b-5 to insider trading require, as necessary conditions for both civil and criminal liability, not only the purchase or sale of securities on the basis of information unknown to the marketplace, but the violation of a duty in so trading.[5] In the case of the traditional insider—the corporate officer, director or controlling party—the duty breached is to the corporation or its shareholders whose stock the insider has bought or sold. While the nexus between the duty breached and the securities traded is problematic even in the case of the traditional insider—does, for example, the corporate insider who sells stock on the basis of inside information owe a duty before or at the time of the purchase to the purchaser (who, prior to the sale, was not a stockholder)?—at least the alleged breach of duty directly relates to the securities sold and the identity of the party on the other side of the transaction. But Winans, as an employee of the Wall Street Journal, was not an insider of the corporations whose stock was traded. The government, therefore, based its prosecution on the theory that Winans had violated a duty he owed to his employer not to disclose the contents of future columns (a term of employment of which Winans was found to have been aware). Breach of duty and the purchase or sale of a security, the conditions precedent to a possible rule 10b-5 violation, became analytically distinct; the duty breached was to one party (the employer), but the purchase was by an entirely different party (the corporation's security holder).

The Supreme Court affirmed the convictions on the communications violations, but split 4-4 on whether Winans' violation of his obligation to his newspaper employer could constitute the basis for a rule 10b-5 violation. Because the court unanimously upheld the convictions on the communications grounds, Justice White's opinion for the Court did not indicate which justices would have upheld the convictions on rule 10b-5 grounds as well, and which justices would have reversed on the same grounds. Nor, quite obviously, did the opinion indicate the content and range of views of the justices on the rule 10b-5 issue. Although the split left standing a Second Circuit decision that upheld the convictions on rule 10b-5 grounds as well,[6] the split seemed to guarantee that the Court would face the issue again in future cases.

The surprise engendered by *Carpenter* was not unique. For example, one would have thought that on the basis of past precedent, the Supreme

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[5] *See infra* text accompanying notes 111-21.

[6] United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).

Court would have decided differently in *Landreth Timber Co. v. Landreth*[7] and *Bateman Eichler, Hill Richards, Inc. v. Berner*,[8] two rule 10b-5 cases that came before the Supreme Court in 1985.[9]

Prediction has been difficult, in large part, because various strands of thought about rule 10b-5 recur and compete for dominance in Supreme Court opinions. The aim of this essay is to identify and untangle these "competing currents." They are: "idealism," "traditionalism," "economic behaviorism," "paradigm case analysis," "literalism" and "textual structuralism." The first three currents might properly be viewed as substantive positions: idealism favors the expansion of rule 10b-5 liability; traditionalism has as its goal to contain rule 10b-5 liability; and economic behaviorism, while inherently not in favor of or against rule 10b-5 liability, would determine the issue of 10b-5 liability according to the economic incentive effects of that liability on the actors concerned. Paradigm case analysis, literalism and textual structuralism are more in the nature of interpretive strategies. Paradigm case analysis calls for the issue of liability to depend upon the similarity of the facts of a given case with certain paradigm fact situations. Literalism favors the language of a statute or regulation in the interpretive process above, and sometimes instead of, all other considerations. Textual structuralism is an interpretive strategy that emphasizes harmony among various parts of a regulatory scheme when interpreting any particular part of that scheme. While certain justices have shown an affinity to both traditionalism and literalism, and other have favored both idealism and textual structuralism, these correlations—particularly that between traditionalism and literalism—have also proved to be quite weak at times.

Recognition of the competing currents can present a richer, more realistic disclosure of Supreme Court jurisprudence with respect to rule 10b-5, especially in its application to insider trading, than is possible with attempted doctrinal statements of the law.[10] In particular, such

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[7]471 U.S. 681 (1985). *See infra* text accompanying notes 141-48 & 159.

[8]472 U.S. 299 (1985). *See infra* text accompanying notes 39-54.

[9]The dominant current in Supreme Court decisions from 1975 through the early 1980's, "traditionalism," had as one of its aims the discouragement of the initiation of causes of action on the basis of rule 10b-5. *See infra* text accompanying notes 66-121. Yet, both *Landreth* and *Bateman Eichler* would seem to encourage the initiation of such actions.

[10]Doctrinal statements—for example, the common aphorism that insiders "must either disclose . . . [inside information] to the investing public, or, . . . abstain from trading" (SEC v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969))—frequently fail to depict accurately the degree to which the law restrains the purchase or sale of securities by those with informational advantages. Such statements both understate the degree of legal proscription, which applies to more than traditional insiders, and overstate the legal restraint because, in some sense, substantially all purchases by corporate insiders are made with an informational advantage not shared by outside investors.

recognition can facilitate our ability to predict future outcomes.[11] In light of the competing currents in rule 10b-5 jurisprudence, the *Carpenter* decision, while not necessarily expected in its exact form as a tie-vote, should hardly have come as a surprise.

I. The Competing Currents: The Past and Present

All justices seek to buttress their conclusions by references to textual language, legislative history,[12] behavioral considerations and other policy concerns. But identification of the competing currents demonstrates substantial differences in nuance and emphasis among the justices. And, as we shall see, how faithfully a justice is prepared to follow the textual language or what policy or incentive effect a justice chooses to emphasize, materially affects the outcome of rule 10b-5 cases.[13]

Various justices subscribe to one or several of the competing currents. Some justices vacillate among them. Sometimes a particular current dominates an opinion to which a majority of the Supreme Court nominally subscribes. Which current dominates may depend on such factors as the time period in which the case comes before the Supreme Court (*i.e.*, a pre- or post-1975 judicial decision) and the justice who is assigned to write the majority opinion (*i.e.*, to which competing current does that justice usually subscribe). True, if another justice feels strongly enough that the reasoning of the majority opinion writer does not comport with his own, he will write a concurrence or, if he disagrees with the result, a dissent,[14] but often the feelings are not so strong as to provoke a separate opinion. At other times, no particular current dominates, but the decision results from an uneasy alliance of several currents pointing in favor of, or against rule 10b-5 liability in the particular case. A third

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[11]*See infra* note 198.

[12]Legislative history, in particular, has been used to support every conceivable position. Section 10(b) of the Securities Exchange Act is quite broadly worded, and thus fails to give specific guidance as to the contours of securities regulation to be promulgated under it. Rule 10b-5 is itself the product of the SEC. Finally, private implied causes of action on the basis of rule 10b-5 were judicially created. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). To divine legislative intent as to the elements of that cause of action when the cause of action, itself, is at most legislatively inspired, rather than specified, often seems farfetched.

[13]The literalist, for example, is far more concerned with text than are traditionalists or idealists. *See infra* text accompanying notes 153-69. In contrast, idealists and traditionalists often seem more imbued with their normative visions of federal securities laws than with analyses which derive easily from legislative history. *See infra* text accompanying notes 15-65 and 66-121.

[14]"Public choice" literature indicates that we should expect multiple opinions to be the norm rather than the exception. *See* Easterbrook, *Ways of Criticizing the Court*, 95 Harv. L. Rev. 802 (1982).

result is also possible: the competing currents cancel each other out, and the Court is unable to reach a decision. This occurred in *Carpenter*.

What are the distinguishing characteristics of the various competing currents and with which justices of the Supreme Court can we associate them? Is it possible to speculate on how the justices who subscribe to one of these currents would have voted in *Carpenter*? It is to these questions that we now turn.

A. *Idealism*

We begin with idealism for two reasons. First, historically its heyday occurred before competing currents of thought were recognizable. But more importantly and for reasons I advance later, its influence still affects the thinking of those justices of the Supreme Court who openly espouse other currents. Hence, while idealism may not command the same support it once did on the Supreme Court, fears about its demise that have long been voiced by scholars and others have not been realized.[15]

What are the distinguishing characteristics of idealism? Idealism is characterized by three elements: first, a striving toward the ideal of equal information among all participants in a securities transaction (or, at least, equal access to information);[16] second, the unabashed espousal of ethics as a source of law; and third, an emphasis upon the need to protect the investing public, and hence, the deterrent function of suits brought on the basis of rule 10b-5, including suits initiated by private parties for damages.[17] This third characteristic implies that the defendant and his conduct rather than the plaintiff and her conduct are the primary factual foci of the justice.

The ideal of equal access to information by all investors appeared in many of the early, landmark rule 10b-5 cases such as *SEC v. Texas Gulf Sulphur Co.*,[18] a 1968 decision. Although *Texas Gulf Sulphur* was

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[15]*See, e.g.*, Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 Bus. Law. 883, 897 (1976).

[16]*See generally* Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 Geo. L.J. 1083 (1985). For an earlier academic expression of idealism, although somewhat more limited than that expressed by Professor Seligman, see Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 Harv. L. Rev. 322 (1979) (rule 10b-5 should be interpreted to bar the exploitation of "unerodable advantages that one trader has over another").

[17]For an insightful critique of this emphasis upon deterrence, at least in the context of private party suits on the basis of rule 10b-5 or other implied causes of action under the securities acts, see Frankel, *Implied Rights of Action*, 67 Va. L. Rev. 553 (1981). In contrast to the "idealist" emphasis upon deterrence, "traditionalist" decisions have emphasized the plaintiff's position and, in particular, the question whether the plaintiffs deserve to be compensated for their alleged loss. *See infra* text accompanying notes 76-80, 101-09.

[18]401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

itself the decision of the Second Circuit Court of Appeals, the Supreme Court seemed to be moving towards the same parity of information stance. In *Affiliated Ute Citizens v. United States*,[19] for example, the disparity of information about the presence of another and higher market for the shares of stock sold by the seller Indians to the buyers, employees of the First Security Bank of Utah who also made a market in such stock, was an important contributor to the Court's holding that the plaintiff sellers need not allege and prove any reliance upon the buyers' omissions.[20]

The goal of deterrence in order to protect the investing public was also highlighted in the early 10b-5 cases. The attention of the Court seemed to focus primarily upon the conduct of the defendants and the need to deter them and similarly situated parties from either misleading investors or trading on the basis of information from which others were excluded. Other than requiring that the plaintiffs, themselves, must have bought or sold securities (a requirement seen as limiting the class of plaintiffs to those who had been injured),[21] the Court devoted little attention to the actual plaintiffs and their equities (as contrasted with those of the investing public generally). This tendency is most apparent in *J.I. Case Co. v. Borak*[22] and *Mills v. Electric Auto-Lite Co.*,[23] two Supreme Court opinions that dealt with implied causes of action under rule 14a-9[24] (the anti-fraud provision of the proxy regulations), but nonetheless had much to say about all implied causes of action brought on the basis of misleading disclosures or omissions,[25] especially those

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[19]406 U.S. 128 (1972).

[20]This is not to say, however, that the Court fully adopted a parity of information stance. The Court emphasized that a duty of disclosure arose because the defendants had been active in making a market for Ute Development Corporation stock. *Id.*

[21]Even this requirement was the product of a Second Circuit decision, Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). In 1975, the Supreme Court explicitly adopted the *Birnbaum* doctrine. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[22]377 U.S. 426 (1964).

[23]396 U.S. 375 (1970).

[24]Rule 14a-9, 17 C.F.R. § 240 (1987), states:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Its language, then, closely parallels that of Rule 10b-5(2). *See supra* note 3.

[25]*See Borak*, 377 U.S. at 433-35; *Mills*, 396 U.S. at 381-85.

based upon rule 10b-5.[26] The Supreme Court showed scant interest in such questions as whether the actual litigating shareholders knew the omitted facts or had actually been injured, both factors in determining what the ultimate remedy would be.[27]

The heyday of idealism occurred prior to 1975, after which traditionalism gained the upper hand.[28] Yet, while idealism, evidenced by the espousal of the ideal of equal access and the need to protect the public by deterring similarly situated insiders, went into a tailspin, it has remained the dominant current of thought among Justices Blackmun, Marshall and, for the most part, Brennan, although each of these Justices has, at times, adopted other modes of reasoning as well.[29] Their idealism has been evidenced by their dissents in *Aaron v. SEC*[30] and *Dirks v. SEC*,[31] and by the dissents of Justices Blackmun and Marshall in *Chiarella v. United States*.[32] In these dissents, the ethical underpinnings of idealism became much more patent than in earlier idealist opinions.

The *Dirks* case, decided in 1983, involved Equity Funding Corporation, which wrote and then sold insurance policies to reinsurers. Secrist, a former officer of Equity Funding, tipped Dirks, an insurance stock analyst and broker for an investment banking firm, that many of the insurance policies written by Equity Funding were fictitious.[33] Dirks then set out to investigate the allegation. In the course of his investigation, Dirks apparently made some effort to encourage a reporter for the Wall Street Journal to write an expose about the matter and to prompt the SEC to initiate an investigation on its own, although the extent of Dirk's efforts with respect to the Journal and the SEC was a point of some dispute. In any event, Dirks also communicated with some of his institutional clients about Secrist's allegations and the extent of his own

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[26]*See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (the *Mills* materiality standards, *see infra* text accompanying note 107, used to support the conclusion that "positive proof of reliance is not a prerequisite to recovery"); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) (*Borak* cited to support the statement, "[i]t is now established that a private right of action is implied under § 10(b)").

[27]Ultimately, in *Mills*, after many years of litigation, the plaintiffs were denied a monetary remedy because the terms of the transaction involving a merger between Mergenthaler Linotype Company and Electric Auto-Lite Company, were deemed favorable to the suing shareholders. Mills v. Electric Auto-Lite Co., 552 F.2d 1239 (7th Cir. 1977).

[28]*See infra* text accompanying notes 66-121

[29]For example, Justice Marshall was quite traditionalist in his opinion in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (*see infra* text accompanying notes 103-08), and Justice Blackmun has been the most forceful voice for the current of "textual structuralism." *See infra* text accompanying notes 170-83.

[30]446 U.S. 680, 704 (1980).

[31]463 U.S. 646, 667 (1983).

[32]445 U.S. 222, 245 (1980).

[33]*Dirks*, 463 U.S. at 649.

investigation to confirm such allegations. The institutional clients were generally able to sell their stock in Equity Funding at a price substantially higher than the market price of the stock after the news of the fraud became public. The SEC censured Dirks for violating rule 10b-5.[34]

Although a Supreme Court majority exonerated Dirks,[35] Justice Blackmun dissented in an opinion joined by Justices Marshall and Brennan. Justice Blackmun's dissent illustrates the idealist stance. To Justice Blackmun, the fact that Dirks' investigation helped to expose the fraud hardly justified his conduct: "Even assuming that Dirks played a substantial role in exposing the fraud, he and his clients should not profit from the information they obtained from Secrist."[36] Most indicative of the tenor of the idealist position was Blackmun's open espousal of ethics as a source of law: "As a citizen, Dirks had at least an ethical obligation to report the information to the proper authorities."[37]

Having kept idealism alive in dissents such as that in *Dirks*, Justices Blackmun, Marshall and Brennan were able to collect a majority for its expression in both *Herman & MacLean v. Huddleston*[38] and *Bateman Eichler, Hill Richards, Inc. v. Berner*.[39] The former of these cases, decided in 1983, is of primary interest as a portent of things to come. The Supreme Court, per Justice Marshall, held that the purchaser of securities who asserts that a prospectus contained misrepresentations has a 10b-5 claim, despite the presence of an express remedy in the Securities Act of 1933 dealing with that context.[40] The Court further held that the allegedly defrauded purchaser need only prove his case by a preponderance of the evidence.[41] *Herman & MacLean*, with its encouragement of rule 10b-5 litigation, its rejection of a state standard of proof in such litigation, and its reference to the "broad remedial purposes" of the Securities Acts,[42] evinced that, although other currents may have eclipsed idealism for a five to seven year period, idealism as a significant

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[34]*Id.* at 651-52.

[35]*See infra* text accompanying notes 120-21.

[36]463 U.S. at 677.

[37]*Id.*

[38]459 U.S. 375 (1983).

[39]472 U.S. 299 (1985).

[40]*Herman & MacLean*, 459 U.S. at 387.

[41]*Id.* at 390. The Court of Appeals for the Fifth Circuit had ruled that the plaintiff must prove his case by "clear and convincing" evidence, a much harder standard to satisfy. Huddleston v. Herman & MacLean, 640 F.2d 534, 545-46 (5th Cir. 1981). The "clear and convincing" evidence standard comes from the common law of fraud. Thus, the Supreme Court's decision in *Herman & MacLean* was a departure from the Court's pattern of referring to state law to determine the elements of a rule 10b-5 suit. *See infra* text accompanying notes 66-121.

[42]459 U.S. at 386.

current had staged a substantial comeback. For present purposes, however, *Bateman Eichler*, decided in 1985, is the more interesting case.

In that case, tippees, who had received confidential information from a broker dealer regarding a gold discovery by a corporation whose stock was traded over the counter, sued the broker who touted the stock to them.[43] They also sued the principal of the corporation, who had advised the tippees that the broker was a "trustworthy and . . . good man." Although the stock initially skyrocketed in value, the inside information ultimately proved to be false, and the value of the stock plummeted. The tippees sued on the basis of rule 10b-5. The defendants sought to dismiss the suit on *in pari delicto* grounds: namely, that the plaintiffs, who were also guilty of violating the law, should be precluded from suing the defendant tipper.[44]

If *Herman & MacLean* was an aberration confined to the question of remedy, one would have expected the defendants to prevail on their motion to dismiss.[45] Anyone but a formalist legal scholar would acknowledge the tremendous influence of facts on a case, not simply in the sense of determining whether a given legal principle is to be applied, but also in the sense of affecting the court's interpretation of the elements of that legal principle. If the plaintiffs in *Bateman Eichler* had knowingly used inside information to purchase their stock, they had been hoisted by their own petards and surely no one, including a court, should rescue them! Moreover, liberal application of such common law defenses as the *in pari delicto* defense would have much the same effect as application of such common law elements of the fraud cause of action as scienter or violation of a duty. It would serve to restrict the number of such rule 10b-5 cases that could be successful and, therefore, *ex ante* discourage their initiation. However, in an opinion by Justice Brennan, the Supreme Court held that the case should not have been dismissed.[46]

Although Justice Brennan did not completely rule out the possibility of an *in pari delicto* defense[47] in private suits based upon alleged violations

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[43]*Bateman Eichler*, 472 U.S. at 301.

[44]*Id.* at 305.

[45]Indeed, the District Court for the Northern District of California had dismissed the suit on *in pari delicto* grounds, although the Court of Appeals for the Ninth Circuit had reversed. *See* Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984).

[46]*Id.* at 310-11.

[47]Justice Brennan, speaking for the Court, stated:

> [A] private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.

of rule 10b-5, he quite explicitly disagreed with the notion "that an investor who engages in such [insider] trading is necessarily as blameworthy as a corporate insider or broker-dealer who discloses the information for personal gain."[48] In Justice Brennan's words, "we do not believe that the tippee properly can be characterized as being of substantially equal culpability as his tippers."[49]

More important than the actual holding of *Bateman Eichler* were the idealist themes that Justice Brennan openly espoused. Quite explicitly, Justice Brennan laced his opinion with the need to protect the "public" and the deterrent nature of the rule 10b-5 suit, even when initiated by private parties. For example, citing *J.I. Case Co. v. Borak*,[50] Justice Brennan noted that "we [the Supreme Court] repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.' "[51] In other words, the culpability of the defendants' conduct and the conduct of those similarly situated was the focus of Brennan's opinion, rather than the plaintiffs' conduct, and the implied right of action was viewed in a very positive light, rather than the negative light in which it had been viewed in traditionalist opinions that preceded *Bateman Eichler*. To Brennan, "*deterrence* of insider trading most frequently will be maximized by bringing enforcement pressures to bear on the sources of such information—corporate insiders and broker-dealers."[52]

Like Justice Blackmun in his dissent in *Dirks*, Justice Brennan did not shy away from highlighting the ethical dimension that supports the idealist view. To some, the impossibility of ever achieving complete parity of information between transacting parties conduced toward a view that insider trading should be tolerated, indeed perhaps encouraged, as the key to other benefits.[53] But to Brennan, speaking for the Court, the ideal remains:

Id.

In Pinter v. Dahl, 108 S. Ct. 2063 (1988), the Supreme Court extended the *in pari delicto* defense to actions brought under § 12(1) of the Securities Act of 1933. In so doing, it reaffirmed this test for the application of the defense which it had enunciated in *Bateman Eichler*.

[48]*Bateman Eichler*, 472 U.S. at 312.

[49]*Id.* at 314.

[50]377 U.S. 426 (1964).

[51]*Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

[52]*Id.* at 316 (emphasis added).

[53]*See, e.g.*, Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1 (1980); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Studies 801 (1980).

> We also believe that denying the *in pari delicto* defense in such circumstances will best promote the primary objective of the federal securities laws—protection of the investing public and the national economy through the promotion of "a high standard of business ethics . . . in every facet of the securities industry."[54]

Perhaps most interesting about *Bateman Eichler* is the fact that there were no dissents to the decision. All Justices but two joined in Justice Brennan's "idealist" expression of the law. The two were Justice Marshall, whom we know from other opinions generally shares that "idealist" view, and Chief Justice Burger, who simply concurred in the judgment without writing a separate opinion.

At times, then, idealism has been a strong current, indeed a wave in the pre-1975 period; at other times, it has been a weaker current, but one still present in the dissents of some of the Court's members. More recently, a near unanimous majority of the Court has been willing to follow its course in selected cases. What accounts for the endurance of idealism, despite the vicissitudes in its popularity?[55] Can we speculate as to how avowed idealists voted in *Carpenter*?

The recurrence of idealism in majority opinions strongly suggests the existence of a widely-held intuition that affirmative misrepresentations and, under certain circumstances, insider trading are "wrongs."[56] Consensus may be lacking as to what those "circumstances" are, but no sitting Supreme Court Justice is prepared to defend insider trading on moral grounds. Thus, a growing body of literature that, on economic grounds, either justifies insider trading or denigrates the ability of rule 10b-5 practicably to unify ethical and legal norms[57] has had only moderate impact on the Court. One should not expect greater impact from such analysis if it is idealism's patent appeal to ethics as a source of law, rather than, for example, economic arguments that can also be advanced in its favor,[58] that explains its strength.

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[54]472 U.S. at 315.

[55]For some factors that bear on the vicissitudes themselves, *see infra* text accompanying notes 96-102 (suggesting why traditionalism overtook idealism as a dominant force during the latter 1970's) and text accompanying notes 190-98 (suggesting that personnel on the Court and popular sentiment might be moving in opposite directions).

[56]As Donald Langevoort has expressed, the acceptance of rule 10b-5 liability by the courts and the SEC "seems to rest . . . on the strongly held intuition that insider trading is unfair." Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Calif. L. Rev. 1, 2 (1982).

[57]*See, e.g.*, Carlton & Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857 (1983); Cox, *Insider Trading Regulation and the Production of Information: Theory and Evidence*, 64 Wash. U.L.Q. 475 (1986); Dooley, *supra* note 53; Haddock & Macey, *A Coasian Model of Insider Trading*, 80 Nw. U.L. Rev. 1449 (1986); H. Manne, Insider Trading and the Stock Market (1966); Scott, *supra* note 53.

[58]These arguments are summarized in R. Clark, Corporate Law 273-77 (1986).

In turn, this intuition seems rooted in a "truth norm" that pervades much of our legal culture, even if the law does not fully implement it. State fraud actions, consumer warranty law, creditor remedies against debtors[59] and other provisions too numerous to mention have their justification in an obligation to be truthful in one's dealings with others. The same truth norm seems implicated in the situations covered by rule 10b-5 as well. Rule 10b-5's misrepresentation cases patently involve conduct that directly violates an obligation to be truthful. But one can also argue that insider trading is untruthful as well.

Silence, like declaring something to be a fact when it is not so, can be a lie under circumstances where the other transacting party reasonably expects to be informed if the actual facts differ from his understanding of them.[60] Such expectations exist where one party is in a relationship of dependence upon another, such as a trust or certain contractual relationships. But, arguably, such expectations are also reasonably held where only one of two parties to a trade has lawful access to material information affecting the value of the security traded.[61] The insider would want to be told the same information if the insider were standing in the other party's shoes; that is to say, the insider is both aware of and shares the reasonable expectations of the other party. Various ethical sources teach the imperative that one should treat others as one wishes others to treat him.[62] Thus, at least some acts of insider trading can properly be depicted as attempts to avoid this ethical imperative of reciprocal treatment. As such, these acts are disrespectful of others; the insiders would deny to others the treatment that they would reasonably

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[59]*See* R. Clark, *supra* note 58, at 42-45.

[60]*See* S. Bok, Lying: Moral Choice in Public Life (1978).

[61]*See* Brudney, *supra* note 16. At least three situations require differentiation. First, if the party with the inside information has unlawfully gained access to that information, the other investor's expectations have been violated because he simply would not expect the other party's access or use of the information. Second, the party trading on the basis of inside information may have had lawful access to it, but for purposes other than gain in the trading of securities. For example, the corporate officer or director might have such information as a part of his corporate duties, or the newspaper columnist might have access to such information for purposes of writing his column. Third, the party having the inside information might have acquired it lawfully for the very purpose of capitalizing on the information acquired. The argument that one's expectations have been violated seems strongest in the first two situations, and weakest in the third. In the third situation, the second investor would probably also want and think that, if he developed information for the express purpose of investment gains, he could lawfully profit from such information. In other words, while there may be some who would claim to hold expectations of sharing even in the third situation, their expectations (if expressed) would seem to be feigned, or, at least, unreasonable.

[62]*See, e.g.*, I. Kant, Groundwork of the Metaphysics of Morals 88 (H. Paton trans. 1964) (first formulation of the categorical imperative). *See also* Phillips, *The Commercial Culpability Scale*, 92 Yale L.J. 228, 252-53 (1982).

expect for themselves. The relationship between certain instances of insider trading, the truth norm, and a general ethical imperative that calls for mutually respectful conduct among people[63] probably explains best the fact that idealism, despite some setbacks, has endured in Supreme Court opinions.[64]

Finally, how did such idealists as Justices Blackmun, Marshall and Brennan approach the *Carpenter* case? There is little doubt that they voted to affirm the convictions of Winans and his tippees on rule 10b-5 grounds. *Carpenter* implicated all three prongs of the idealist stance: disparity of information; unethical behavior; and the need to deter similarly situated actors. The transactions that formed the basis of the suit were characterized by an informational disparity between the traders. The idealists would especially be concerned with the lack of ethics on the part of Winans and those he directly or indirectly tipped. And because the informational disparity resulted from a misuse of information by Winans, the idealists would stress the need to deter similarly situated parties from behaving in a like manner.[65]

B. *Traditionalism*

The distinguishing characteristics of the traditionalist current include: first, a reluctance on the part of the Supreme Court to have federal courts intrude excessively into areas traditionally reserved to state law; second, even when rule 10b-5 is held to apply to a transaction, explicit or implicit reference to state law, particularly the state law of fraud and fiduciary duties, in order to derive rule 10b-5's substantive content; and third, a tendency to view those plaintiffs who would sue on the basis of rule 10b-5 in a more negative light than the defendants whose alleged conduct necessitated initiation of the litigation. Traditionalism gained the upper hand in rule 10b-5 jurisprudence in 1975 and dominated the Supreme Court's holdings with respect to rule 10b-5 liability at least through 1980. Because it succeeded idealism as the dominant theory espoused by a majority of the Supreme Court, traditionalism is best understood as a reaction to idealism. And because traditionalism looked

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[63]*See* C. Fried, Right and Wrong 67 (1978).

[64]*See* Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 Va. L. Rev. 117, 122-23 (1982).

[65]Significantly, Justices Blackmun and Marshall would have sustained Chiarella's conviction in Chiarella v. United States, 445 U.S. 222, 245 (1980). Although Justice Brennan concurred, voting to overturn Chiarella's conviction, he did so because breach of a duty had not been presented to the jury. Justice Brennan nonetheless stated that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." *Id.* at 239. For a discussion of *Chiarella*, see *infra* text accompanying notes 111-19.

to state common law, especially the state law of fraud, to define rule 10b-5 liability and because that body of law was restrictive in a number of respects,[66] traditionalism can properly be viewed as restrictive; it tended to restrict rather than expand the development of rule 10b-5. Although traditionalism in its reactive and restrictive guise does not now enjoy the same level of support it did some eight years ago, its basic tenet that courts are to refer to state law—such as fraud doctrine, fiduciary duties and property rights—to determine whether rule 10b-5 has been violated still represents a frequently reiterated current in Supreme Court opinions.

The Supreme Court's 1975 decision in *Cort v. Ash*,[67] a case that itself had nothing directly to do with rule 10b-5, signaled a change in the Court's attitude toward privately-initiated suits based upon implied causes of action under federal law.[68] In *Cort v. Ash*, which dealt with the attempt by shareholders to bring suit against the directors of Bethlehem Steel Corporation for violating a federal criminal statute that prohibited corporations from making contributions or expenditures in connection with presidential campaigns,[69] Justice Brennan, speaking for the Court, specified four factors that were relevant to the decision whether to imply a private cause of action under a federal statute.[70] The restrictive nature of the *Cort v. Ash* test is illustrated by one of these factors: "Is there any indication of legislative intent, explicit or implicit, either

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[66]The state common law of deceit has remained quite restrictive. The elements of a tort action for deceit are: a false representation, knowledge or belief that the representation is false, intent to induce the plaintiff to act or refrain from acting in reliance on the misrepresentation, justifiable reliance by the plaintiff, and damage to the plaintiff as a result of the reliance. W.P. Keeton, Prosser and Keeton on Torts 725-28 (5th ed. 1984). *See also* Keeton, *Fraud-Concealment and Non-Disclosure*, 15 Tex. L. Rev. 1 (1936).

[67]422 U.S. 66 (1975).

[68]*See* Frankel, *supra* note 17.

[69]The statute under which an implied cause of action was sought was 18 U.S.C. § 610 (repealed, 1976) which prohibited corporations "from making 'a contribution or expenditure in connection with any election at which Presidential and Vice Presidential electors . . . are to be voted for.' " 422 U.S. at 68 (footnote omitted).

[70]Justice Brennan wrote:

> In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose especial benefit the statute was enacted," —that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

422 U.S. at 78 (citations omitted).

to create such a remedy or to deny one?''[71] If Congress had intended to grant a cause of action, it would be quite likely that an explicit cause of action would exist in the statute. In other words, the most probable context to confront an attempt to imply a cause of action is in that very context where evidence of such intent is lacking. Therefore, to suggest that implied causes of action should be confined to those statutory contexts where evidence of legislative intent to grant such causes of action exists biases the issue against such actions.[72] The application of the four factors, as well as their articulation, left no doubt that the Court had as its primary agenda the restriction, rather than the further expansion, of such implied causes of action.[73]

While *Cort v. Ash* dealt with a statute outside the securities law context, its restrictive tenor was soon reflected in securities law cases,[74] including a variety of rule 10b-5 cases. Having already sustained an implied cause of action under rule 10b-5,[75] the Supreme Court would be unlikely to deny that one existed. But it could, and did, seek to deter the initiation of 10b-5 lawsuits.

Blue Chip Stamps v. Manor Drug Stores,[76] a 1975 case, illustrates the tendency of traditionalism to focus upon the litigating plaintiffs rather than the defendants whose conduct gave rise to the suit. In *Blue Chip Stamps*, the Supreme Court strictly interpreted a long standing Court of Appeals requirement that the plaintiff in a rule 10b-5 case must have been a purchaser or seller of securities.[77] In his opinion for the majority, Justice Rehnquist spoke of the ''danger of vexatiousness [in rule 10b-5 litigation] different in degree and in kind from that which accompanies litigation in general.''[78] *Ernst & Ernst v. Hochfelder*,[79] which

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[71]*Id.*

[72]As Professor Frankel pointed out, following *Cort v. Ash*, the Supreme Court soon ''moved toward a more restrictive test whereby legislative intent came to subsume the other *Cort* factors.'' Frankel, *supra* note 17, at 560.

[73]For example, another test was whether the plaintiff was among the class sought to be benefitted by the statute. There was evidence that one of the purposes underlying the criminal statute was to protect stockholders since it was their money that was being spent. But the Court did not give this factor much weight on the ground that ''the protection of ordinary stockholders was at best a secondary concern.'' Cort v. Ash, 422 U.S. 66, 81 (1975).

[74]*See, e.g.*, Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977) (the Court held that the tender offeror has no implied cause of action for damages under § 14(e) of the Securities Exchange Act of 1934).

[75]*See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Insurance of the State of New York v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

[76]421 U.S. 723 (1975).

[77]*Id.* at 754-55. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

[78]421 U.S. at 739.

[79]425 U.S. 185 (1976).

illustrates the tendency of the Supreme Court to define the elements of a rule 10b-5 claim in terms of the state law of fraud, followed in 1976. The Supreme Court held, in that case, that the plaintiff must prove that the defendant acted with scienter with respect to the words or conduct that gave rise to the action.[80] Justice Powell, speaking for the Court, was hardly crystal clear in defining scienter.[81] But, he did rule out the possibility that scienter was satisfied by a mere allegation of negligence. Although Justice Powell carefully stressed the language of Section 10(b) of the Securities Exchange Act of 1934, pursuant to which the SEC promulgated rule 10b-5, and the structure of remedies in the Act, he nonetheless implicitly drew the parallel to the state law of deceit, with respect to which the defendant must have intended to defraud the plaintiff in order for the plaintiff purchaser to have established his case.[82]

In 1977, Justice White wrote the opinion of the Court in *Sante Fe Industries, Inc. v. Green*.[83] This decision evinced the reluctance of a Supreme Court majority to continue to expand rule 10b-5 to areas that traditionally had been the province of state fiduciary law. Prior to this decision, some federal courts had broadly interpreted the kind of conduct that would give rise to a rule 10b-5 suit. "Fraud" was said to include not only fraudulent words or omissions, but also conduct that in everyday parlance one would think of as fraudulent.[84] Even the Supreme Court, in *Superintendent of Insurance v. Bankers Life and Casualty Co.*,[85] applied rule 10b-5 to a fraudulent series of transactions that lacked any

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[80]*Id.* at 193.

[81]Did it require intentional, knowing or only reckless conduct on the part of the defendant? *See* 425 U.S. at 193-94 n.12.

[82]In note 33 of the opinion, Powell quoted with approval Justice Rehnquist's words in *Blue Chip Stamps* that " '[w]hile much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good.' " 425 U.S. at 214 n.33, (quoting *Blue Chip Stamps*, 421 U.S. at 747-48).

[83]430 U.S. 462 (1977).

[84]*Id.* at 479. *See, e.g.*, Walling v. Beverly Enterprises, 476 F.2d 393 (9th Cir. 1973) (entering into reorganization agreement without intention to perform held actionable under rule 10b-5); Shell v. Hensley, 430 F.2d 819, 826 (5th Cir. 1970) (rule 10b-5 cause of action stated where "[f]airly read, the complaint alleges that defendants, directly or indirectly, caused at least a majority of the Alabama National board" to engage in a securities transaction between two commonly controlled corporations); Bryan v. Brock & Blevins Co., 343 F. Supp. 1062 (N.D. Ga. 1972) (proposed merger to ensure that only "active employees" as shareholders can be challenged on the basis of rule 10b-5), *aff'd on other grounds*, 490 F.2d 563, 570 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974). *But see* Schoenbaum v. Firstbrook, 405 F.2d 200, 210-14 (2nd Cir. 1968), *cert. denied sub nom.* Manley v. Schoenbaum, 395 U.S. 906 (1969) (there can be no rule 10b-5 cause of action where no one is deceived).

[85]404 U.S. 6 (1971).

misrepresentations or omissions of material facts directly relating to the Treasury securities being sold.[86] *Sante Fe Industries* dealt with a "going private" or "freezeout" transaction.[87] The plaintiffs claimed that they were forced to surrender their investment in Kirby Lumber Corporation, which Sante Fe Industries controlled, at only a fraction of the per share value of its net assets. Justice White held, however, that the thrust of rule 10b-5 was the accuracy of disclosure rather than unfairness. If the price, no matter how unfair it was, had been disclosed, then rule 10b-5 did not offer relief. For that, the plaintiffs had to seek relief pursuant to state law.[88]

Three years later the same restrictive trend seemed soundly in place. In 1980, the Supreme Court decided two major cases interpreting rule 10b-5.[89] One of these was *Aaron v. SEC.*[90] One question that had been left open by the Supreme Court's 1976 opinion in *Ernst & Ernst v. Hochfelder*[91] was whether the requirement of scienter applied not only to private causes of action founded upon rule 10b-5, but also to injunctive proceedings initiated by the SEC. The issue generated a plethora of law review commentary,[92] and the circuit courts of appeals had split on the

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[86]In a complicated multi-step transaction, one Begole managed to acquire all the stock of Manhattan Casualty Co. ("Manhattan") from Bankers Life & Casualty Co. ("Bankers Life") for $5,000,000 that was essentially paid out of the sale of nearly $5,000,000 of Treasury bonds owned by Manhattan. Since the action was brought by the Superintendent of Insurance of New York on behalf of Manhattan's creditors, rule 10b-5 was implicated only because the Treasury securities were sold by Manhattan (Bankers Life was not complaining about its sale of Manhattan stock to Begole). As Justice Douglas admitted in his opinion for the Court, "To be sure, the full market price was paid for those bonds . . . ." *Id.* at 9.

[87]Although such transactions can be divided into various categories, such transactions include the element that, following the transaction, the corporation is private rather than public. The public shareholders have been "frozen out," sometimes willingly by selling their shares or concurring to a merger, but often unwillingly. *See* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978).

[88]Technically, this approach involved focusing upon subsection (b) rather than subsection (a) or (c) of rule 10b-5. *See supra* note 3. To the Court, rule 10b-5 concerned misrepresentation, not merely an act or practice which might, in the vernacular sense, defraud an investor. More recently, the Supreme Court, in an opinion by Chief Justice Burger, held that misrepresentation or nondisclosure is also a necessary element of a cause of action based upon §14(e) of the Securities Exchange Act. *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

[89]Besides Aaron v. SEC, 446 U.S. 680 (1980), the Supreme Court decided Chiarella v. United States, 445 U.S. 222 (1980). *See infra* text accompanying notes 111-19.

[90]446 U.S. 680 (1980).

[91]425 U.S. 185 (1976).

[92]*See* Berner and Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of* Hochfelder, 51 N.Y.U.L. REV. 769 (1976); Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After* Ernst & Ernst v. Hochfelder, 77 COLUM. L. REV. 419 (1977).

issue.[93] Justice Stewart wrote the majority opinion for the Court in *Aaron.* The Court held that the same requirement of scienter applied against the SEC even when it brought a suit for an injunction. And given the facts of the case, Justice Stewart's opinion can also fairly be read as saying something quite significant about the definition of scienter itself.[94]

Aaron stood at the zenith of the Supreme Court's apparent lack of concern with deterrence of misleading statements or conduct. Even the agency charged with enforcing the 1934 Act could not seek to stop continuing securities acts violations under rule 10b-5 without alleging and proving the state law-derived element of scienter.[95] This attitude stood in sharp contrast with that which had characterized the Supreme Court's opinions of less than a decade earlier. Why had the Supreme Court turned so restrictive?

Various reasons could be, and were advanced for the trend reversal that had occurred in 1975 and still seemed in place in 1980.[96] The *Sante Fe* case suggested that the Court was concerned with federalism, and specifically, with the prospect of an open-ended doctrine such as rule 10b-5 usurping all state law respecting the governance of corporations.

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[93]*Compare* SEC v. Cowen, 581 F.2d 1020 (2d Cir. 1978) (scienter not required) *with* Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979) (scienter required).

[94]With respect to a definition of scienter, the narrow holding of the Supreme Court's opinion in *Ernst & Ernst v. Hochfelder* was negative, scienter did not include negligence. Whether scienter could be satisfied not only by intentional conduct to deceive, but also by knowing or reckless conduct, was still unsettled. Aaron, himself, was the branch manager of a brokerage concern who was aware—i.e., knew—that salespersons in his office were promoting the sale of a security with false claims. He did little to insure that the salespersons ceased the practice. In addition to the explicit holdings, then, that the *Ernst & Ernst* requirement of scienter applied to the SEC as well as private parties, and that it applied in a suit for injunctive relief, the Supreme Court's opinion might be interpreted as implying that mere knowledge did not suffice to constitute scienter. If knowledge did not suffice, nor could mere recklessness.

[95]If one takes seriously the need to protect the public, then requiring something more than negligent conduct, particularly in the circumstances present in the *Aaron* case, would seem to be counterproductive. First, the higher the state of scienter required, the more difficult the burden of proof the plaintiff must meet. Even if the defendants intentionally sought to mislead the plaintiffs, proof of intention, whether in civil or criminal law, has historically posed great obstacles. Some truly guilty parties will win simply because of the difficulty of proof. Second, either where misleading statements have been made or material facts omitted, the investing public has been injured whether the party who produced the facts or omitted them acted intentionally, recklessly, or negligently. If one concentrates upon the need to deter conduct that can harm the investing public, then, it is not clear that one would make the distinction. This is especially the case if one speaks about an action by the SEC for an injunction.

[96]*See* Conard, *Securities Regulation in the Burger Court*, 56 U. Colo. L. Rev. 193 (1985); Frankel, *supra* note 17.

Moreover, equal access to information, at least in the sense of information that is immediately usable in the investment decision, is an ideal that can hardly be realized. Consequently, one is inevitably expanding the law trying, but never being able, to achieve the goal. Similarly, unless one speaks in cost-benefit terms (a frame of analysis almost wholly lacking among those adopting the idealist stance), deterrence is a "good" of which one cannot get enough. More litigation, in other words, is axiomatically better. There is always some insider trading or unequal access to information that must be discouraged. At some point, "over-enforcement" results; some socially useful conduct is restricted, and, in any event, the costs (including the litigation costs) of deterrence exceed its benefits at the margin.[97]

The general tightening of requirements for such actions, including the reaffirmation of the standing requirement in *Blue Chip Stamps*, enunciation and elaboration of the scienter requirement in the *Ernst & Ernst* and *Aaron* cases, and the tightening of the materiality standard in *TSC Industries v. Northway, Inc.*,[98] all indicated that the Supreme Court was interested not in encouraging more litigation, but in reducing the volume of suits brought on the basis of rule 10b-5.[99] To accomplish this required a philosophy other than idealism. This desire to reduce the volume of litigation, if true, would correspond to a general desire, stated repeatedly by Chief Justice Burger during those same years, to reduce the workload of the federal judiciary.[100] Limiting the opportunity to bring suit on the basis of rule 10b-5, then, can be seen as an integral aspect of a broader strategy implementing such a reduction.

There also seemed to be a feeling that rule 10b-5 had been misused, at least when private parties brought suit. Private suits had at first seemed quite equitable on the theory that private parties had in fact been deceived, and an implied cause of action on the basis of rule 10b-5 was the equivalent of giving that deserving private party the federal analogue of a fraud cause of action. If the plaintiffs were deserving, and if the dominant focus was on the need to protect the investing public from conduct such as that engaged in by the defendants, why not construe the elements of this new cause of action quite liberally so as to attain the maximum deterrence? However, an increasing number

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[97]*See* Frankel, *supra* note 17, at 572-78.

[98]426 U.S. 438 (1976).

[99]*See* Conard, *supra* note 96, at 216-17.

[100]*See, e.g.*, *Chief Justice Burger's 1977 Report to the American Bar Association*, 63 ABA Journal 504 (1977) (expressing support for the elimination of diversity jurisdiction because the federal courts were overburdened); *Chief Justice's Yearend Report, 1977*, 64 ABA Journal 211 (1978) (supporting elimination of the mandatory appeal jurisdiction of the Supreme Court).

of cases seemed to involve not private parties who in fact had been deceived, but sophisticated investors who had not necessarily relied on the alleged omission or false statement.[101] These investors were using implied causes of action, such as that based upon rule 10b-5, as a strategic tool in the context of larger corporate battles.[102]

TSC Industries v. Northway, Inc.[103] illustrates this phenomenon. Although this was not brought as a rule 10b-5 case—the allegation by the plaintiffs in *TSC Industries* concerned alleged omissions in the proxy statement of a corporation, and suit was brought on the basis of rule 14a-9—the standard of materiality articulated by the Supreme Court case was interpreted to apply to rule 10b-5 cases as well.[104] On the basis of *Mills v. Electric Auto-Lite Co.*,[105] one would have thought that a misstatement or omission was material if "it *might* have been considered important by a reasonable shareholder who was in the process of deciding how to vote."[106] But the Supreme Court, in an opinion written by Justice Marshall, interpreted *Mills* to have held only that materiality substituted for proof of reliance in a rule 14a-9 case rather than to have defined materiality. Justice Marshall, who was the author of the Court's opinion in *TSC Industries*, then carefully laid out a definition of materiality that subtly, but substantially, differed from the apparent definition found in *Mills*: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote."[107] The "might" of *Mills* became the "would" of *TSC Industries*. Although the verbal change seemed slight, the consequences

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[101]For example, the plaintiffs suing on the basis of rule 10b-5 have included business enterprises, professional investors and insiders under circumstances patently illustrating that the plaintiffs had not been deceived by the alleged misrepresentations or omissions. *See, e.g.*, Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981) (a professional investor's suit on the basis of rule 10b-5 dismissed where the corporate statements alleged to have been misleading were not determinative factors in his decision to purchase the stock); Allen v. H.K. Porter Co., 452 F.2d 675, 679 (10th Cir. 1971) ("knowledgeable" plaintiffs, who were a security brokerage firm and its clients, brought suit when "there was 'no semblance whatever of a lawsuit' "); Harnett v. Ryan Homes, Inc., 360 F. Supp. 878 (W.D. Pa. 1973) (former vice-president of a corporation unsuccessfully sought to sue the corporation on the basis of rule 10b-5).

[102]*See, e.g.*, Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969).

[103]426 U.S. 438 (1976).

[104]*See, e.g.*, Starkman v. Marathon Oil Co., 772 F.2d 231, 238 (6th Cir. 1985); Basic Inc. v. Levinson, 108 S. Ct. 978, 983 (1988).

[105]396 U.S. 375 (1970). Significantly, Justice Harlan's opinion in *Mills* fits the idealist mode. It is laced with references to the need to protect the public, for deterrence, and, unlike traditionalist views, dismissive of state law elements as restrictive of a federal cause of action.

[106]*Id.* at 384 (emphasis added).

[107]426 U.S. at 449 (emphasis added).

were not. To plaintiffs, the change in wording made the difference between being able to secure a judgment as a matter of law on the pleadings and having to spend resources at trial to prove materiality.[108]

For our purposes the key to Justice Marshall's opinion lies in the identity of the plaintiff. The initiator of the suit was Northway, Inc., which held 2,000 shares of TSC stock. Although all the omissions from the proxy statement about which Northway complained seemed to be material even by the more restrictive definition laid down by Justice Marshall, substantially all the omitted facts must have been known to a corporate investor like Northway, presumably the recipient of sophisticated investment advice. For example, one omission was that National Industries, which was on one side of the transaction to be voted on, controlled TSC Industries, which was the other party to the transaction, and whose shareholders were asked to vote. Thus Northway was using an implied cause of action based upon inadequate disclosure not because it had been misled, but simply to buttress its case; use of the materiality doctrine (although the elements of the doctrine may have been satisfied) did not seem to square with the motivation for the suit.

Whatever the reasons and motivations for the Supreme Court's swing from idealism to traditionalism[109]—a swing so strong as to carry with it Justice Brennan in *Cort v. Ash* and Justice Marshall in *TSC Industries*—the key respect in which traditionalism has specifically affected rule 10b-5's application to insider trading is the necessity for finding that the defendants have violated some duty owed under state law (e.g., the fiduciary duty that officers and directors owe to the corporation and its shareholders).[110] Violation of a duty under state law as a precondition to liability under rule 10b-5 for insider trading is illustrated by Justice Powell's opinions for the majority in two key cases: *Chiarella v. United States*[111] and *Dirks v. SEC*.[112]

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[108]For example, in TSC Industries, Inc. v. Northway, Inc., 512 F.2d 324 (7th Cir. 1974), the district court denied Northway's motion for summary judgment on the issue of liability, but the court of appeals reversed, holding the omissions material as a matter of law. The actual decision of the Supreme Court was to reverse the court of appeals and hold that Northway was not entitled to summary judgment on the issue of liability.

[109]Another reason for containing rule 10b-5 litigation was that the problems of damages in private suits proved to be quite formidable. For example, unlike the plaintiff, the defendant in a rule 10b-5 suit need not have been a purchaser or seller. But even if he was, the defendant may have only traded a small number of shares. The damages the plaintiff alleged to have suffered might be disproportionate to the defendant's gain (if one existed). Were damages in such suits to be limited to the defendant's gain, or was the plaintiff to be allowed the full amount of his alleged loss?

[110]For an excellent exploration of this aspect of traditionalism, see Langevoort, *supra* note 56.

[111]445 U.S. 222 (1980).

[112]463 U.S. 646 (1983).

Chiarella was an employee of Pandik Press, a financial printer that, *inter alia*, printed tender offer statements. Although the names of the tender offer targets were omitted from the various printer's proofs until the very last printing, Chiarella was able to determine certain tender offer targets on the basis of the information presented in the tender offer statement. Chiarella then purchased the stock, or call options that enabled him to purchase the stock at a set price, of the tender offer targets at a price that did not yet reflect the high probability, or even in some cases the certainty, of a tender offer being made for the shares of stock. The United States successfully brought a criminal suit against Chiarella on the basis of rule 10b-5,[113] and his conviction was sustained by the Second Circuit Court of Appeals.[114] But the Supreme Court, per Justice Powell, reversed, holding that the mere trading on the basis of information unknown to the marketplace could not constitute a violation of rule 10b-5.[115] Justice Powell specifically rejected the "idealist" current that had dominated the Court of Appeals' opinion:

> Its decision thus rested solely upon its belief that the federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions." The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.[116]

Rather, what is required is "the element . . . to make silence fraudulent—a *duty* to disclose . . . ."[117] And that duty must be found in law other than rule 10b-5 itself. For example, to consider the paradigm case of conduct that would violate rule 10b-5—the corporate officer or director who profits by the use of information confidential to the corporation and known to him because of his officership or directorship—there would be a breach of his fiduciary duty as an officer or director to use the corporate property (including any information) for the benefit of the corporation and its shareholders rather than himself.[118] But Chiarella, of course, was not an insider, that is, an officer or director, having fiduciary duties under state law. Nor did he, as in the case of many tippees, get his information from such an insider, for even the

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[113] 450 F. Supp. 95 (S.D.N.H. 1978).

[114] 588 F.2d 1358 (2d Cir. 1978).

[115] 445 U.S. 222 (1980).

[116] *Id.* at 232.

[117] *Id.* (emphasis added).

[118] *See* Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 Rutgers L. Rev. 184 (1979).

tender offeror could not be considered an "insider." In Justice Powell's opinion, the government failed to allege (and thus, *a fortiori*, to prove) violation of any other duty.

Chiarella thus put to rest the most expansive reading of rule 10b-5—much of it derived from the Second Circuit's landmark decision in *SEC v. Texas Gulf Sulphur*[119]—that rule 10b-5 itself was the source of a duty to abstain from trading or to disclose the information on which one wanted to trade.

Dirks v. SEC,[120] unlike *Chiarella*, did involve a corporate insider having fiduciary duties under state law. However, the insider, Secrist, was viewed as not having violated any duties because his own motivation was to expose rather than to profit. In his opinion for the Court, Justice Powell again articulated his "duty"-dependent analysis, this time in regard to the liability of a tippee.[121] There was no doubt that Dirks had both used, and profited from, the use of inside information. However, Powell held that use and profit from inside information, by themselves, could not spell liability. Rather, the tippee's liability depended upon the breach of fiduciary duty by the corporate insider and upon the tippee's knowledge of that breach. In this particular case, according to Justice Powell, Secrist had not breached his fiduciary duty because he had not exposed the fraud for personal gain. Quite the contrary, one could argue that Secrist had acted most properly in trying to expose the fraud.

Traditionalism, then, looks to state law. First and foremost it looks to the state law of fraud as the central focus of rule 10b-5; hence the very strong scienter requirement and the emphasis that the thrust of a complaint must allege a disclosure problem, not other conduct that is allegedly unfair or even fraudulent in a vernacular sense. But traditionalism also looks to other state law. Most importantly, with respect to rule 10b-5 regulation of insider trading, it looks to the state law of agency. In most cases, this will involve a reference to the state law of fiduciary duties. The necessity for finding a violation of a duty on grounds other than the use of information unknown to others in the marketplace puts traditionalism at odds with, and explains the characterization of it as a reaction against, idealism.

Nor is this emphasis upon violation of duties an abstract proposition. The traditionalist judge would want to see a direct nexus between the violation of the duty and the act that allows prosecution to be based, or suit to be brought, pursuant to rule 10b-5, that is, the purchase or

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[119]401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[120]463 U.S. 646 (1983). For a discussion of *Dirks*, see *supra* text accompanying notes 31-37.

[121]Note that Dirks can be considered both a tippee—from Secrist, the insider—and a tipper—to his institutional clients who had profited by his research unknown to the marketplace.

sale of securities. Given the reluctance of state law to grant relief even in instances of insider trading where the party purchasing or selling securities on the basis of inside information is a true insider, and given the strong attraction of traditionalism for state law, it is quite inconceivable that the traditionalist judge would apply rule 10b-5 to the nontraditional context presented by *Carpenter*. To hold otherwise would undermine the authority of the *Sante Fe* case, one of the icons of traditionalist rule 10b-5 jurisprudence. Thus, we can safely speculate that those justices on the Court who have actively promoted this current of thought in their opinions, such as Chief Justice Rehnquist and Justice White, voted not to sustain the convictions in *Carpenter* on rule 10b-5 grounds.

C. *Economic Behaviorism*

Every current we have identified has a behavioral dimension. We have seen that one of the primary functions of traditionalism, placed in historical context, was to deter the initiation of litigation based on implied causes of action such as rule 10b-5. This is not to say, of course, that traditionalists have always been frank in espousing that goal. In contrast, idealists quite openly aspire to modify the behavior of actors outside the litigation context. Idealism seeks to promote the disclosure of information or, lacking fulfillment of that objective, to deter trades in which the participants lack parity of information.[122]

Like idealism, another current—"economic behaviorism"—is directed to conduct outside litigation. Unlike idealism and traditionalism, however, this current does not view insider trading, or litigation based upon its occurrence, as necessarily positive or negative. Economic behaviorism considers the law of insider trading as bearing on the production of information.[123] The ability to trade on the basis of information unknown to others in the marketplace may stimulate the production of information. In that respect, insider trading should not necessarily be discouraged. On the other hand, not all use of information is desirable. If one party has property rights in certain information, its use in a trading or other context by another will be a theft of that information. Unless deterred, that trading lessens the value of the information to its owner and, indirectly, discourages its original creation. The task of the law, then, becomes drawing the line that differentiates the legal from the illegal in such a way as to encourage the creation and use of information that is socially productive. Unlike idealism and traditionalism, economic be-

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[122] *See* Seligman, *supra* note 16.

[123] *See* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Sup. Ct. Rev. 309 (1981).

haviorism is neither inherently expansionary nor restrictive. It may lead to findings of liability in certain cases and conclusions that rule 10b-5 has not been violated in others.

To illustrate this economic behaviorist view and its differences from both idealism and traditionalism, consider three examples: first, the corporate insider who, knowing of a corporate development before the disclosure of information to the marketplace, trades on that information; second, the printing employee who determines from materials he is printing that a tender offer is to be made for a particular target and profits from that insight; and third, the security analyst who, on the basis of his research and thought-processes, determines that a particular security is overvalued and, for profit, communicates that information to his clients prior to disclosing his conclusions to the marketplace as a whole.

A strict economic behaviorist, *i.e.*, one who determines the legality of insider trading on economic behavioral considerations alone, might either condone or condemn the insider's trading in the first of these three examples. Before arriving at the ultimate question of legality, the behaviorist would want to know answers to certain questions. Is the ability to trade on the basis of inside information an incentive for the insider to have developed the information in the first place? Does the corporation indirectly get the benefit through the ability to compensate such an officer at a level lower than he would otherwise demand for his services?[124] Is any reduction in pay at least equal to the value the information would have to the corporation if the insider had not exploited the information for trading purposes? Finally, does either a rule that allows the insider to trade or one that forbids trading offer advantages in reducing the cost of transacting between the corporation and the insider? Although certain academics have advocated economic behaviorism even as applied to the insider in this example,[125] no present justice of the Supreme Court has openly equated economic behaviorism with the law that should be applied to such facts. Nonetheless, the academic literature has influenced the court, and that influence has been felt in judicial reactions to the other two examples posed.

The second example, the printer who profits on the basis of information about a tender offer target, resembles in rough outline the facts of *Chiarella v. United States*.[126] I have already alluded to the idealist dissents in *Chiarella*[127] and the traditionalism voiced by Justice Powell

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[124]*See* Cox, *supra* note 57, at 488-92; Haddock & Macey, *supra* note 57, at 1460-62.

[125]*See, e.g.*, Carlton & Fischel, *supra* note 57, at 867-68.

[126]445 U.S. 222 (1980).

[127]*Id.* at 245-52. *See also supra* text accompanying notes 28-32.

in his majority opinion.[128] Chief Justice Burger's dissent[129] illustrates an economic behaviorist position. Unlike the idealists, Burger would neither try nor even want to rectify all informational inequalities between sellers and buyers. On this score, he agreed with Justice Powell that, "[a]s a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation."[130] However, unlike the traditionalist who would justify the necessity for finding a violation of a duty primarily on the basis that state law incorporates such a requirement, Burger justified such a limitation of liability in terms of its incentive effects: "This rule permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting."[131] Why, then, did Burger dissent? That is, why would he have upheld Chiarella's conviction?

Chief Justice Burger's economic behaviorism led him to suggest one version of the misappropriation theory.[132] If the basis for concluding that there is no liability generally is the desire to influence the behavior of the transactor, then surely there are some situations where the securing and evaluating of relevant information are not the product of superior skill and experience and, indeed, should be discouraged:

> [T]he policies that underlie the rule also should limit its scope. In particular, the rule [of no liability generally] should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.
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> [The conduct of] [a]n investor who purchases securities on the basis of misappropriated nonpublic information . . . quite clearly serves no useful function except his own enrichment at the expense of others.[133]

Chief Justice Burger thus, "would read §10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[134]

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[128] *See supra* text accompanying notes 111-18.
[129] 445 U.S. at 239-44.
[130] *Id.* at 239-40.
[131] *Id.* at 240.
[132] *See generally* Aldave, *supra* note 2, at 101.
[133] 445 U.S. at 240-41.
[134] *Id.* at 240.

Chiarella did misappropriate information from his employer. Financial printers must observe the confidentiality of their clients. Without that confidentiality, news would leak to the markets, often to the prejudice of the client. Hence, the financial printer with a reputation for leaking information is hardly a printer with bright prospects. But Chief Justice Burger's articulation of the duty owed and therefore breached—particularly his use of the phrase, "an absolute duty to disclose"—implied that the printing employee owed a duty that extended well beyond the printer's employer or even the employer's client, the tender offeror. Once having failed to refrain from trading, the printer offended a duty of disclosure owed to the investing public, or at least a subset of that investing public consisting of the target corporation's shareholders who had sold their stock.[135]

Consider now the third example, that of the investment analyst who investigates and concludes on the basis of his investigation that a security is either over- or undervalued by the marketplace and communicates that judgment to his clients prior to disclosing it to the public at large. While the security analyst may trade or advise others to trade on the basis of inside information, one may argue that the production of information leads to better investment decisions and promotes allocational efficiency. Because the production of information is considered a positive good, the judge approaching the question from the production of information perspective would tend to find that this use of inside information is not illegal. Without the ability to use the information, there simply would not be an incentive to produce the information.

The third example is based on the facts of *Dirks v. SEC.*[136] I have already referred to the idealist dissent in *Dirks* by Justices Blackmun, Brennan and Marshall[137] and to the traditionalist basis of Justice Powell's majority opinion that exonerated Dirks, the investment analyst, from liability.[138] Part of Powell's reasoning, however, seemed to have been influenced by Chief Justice Burger's earlier expressed economic behaviorism:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognized is necessary to the preservation of a healthy market. It is com-

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[135]At least one prominent academic authority supports Burger's conception of the misappropriation theory. *See* Langevoort, *supra* note 56.

[136]463 U.S. 646 (1983).

[137]*See supra* text accompanying notes 31-37.

[138]*See supra* text accompanying notes 120-21.

> monplace for analysts to "ferret out and analyze information," . . . and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analysts' judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.[139]

Were Chief Justice Burger still on the Supreme Court, it seems clear that he would have voted to sustain the conviction of Winans and the tippees involved in the *Carpenter* case on rule 10b-5 grounds. In fact, the government's theory in *Carpenter*, that Winans breached the duty he owed to his employer, the Wall Street Journal, is less embracing than Burger's conception that Chiarella owed both a duty of silence towards his employer and, once having violated the duty of silence, a duty of disclosure towards investors in the marketplace. The government's theory could only be used to justify civil or criminal enforcement actions brought by the government itself. In contrast, Burger's theory would seem to allow private investors to initiate causes of action against the misappropriator. It seems clear, however, that no one presently sitting on the Court, with the possible exception of Justice Scalia,[140] whose views on this subject are presently unknown, has adopted economic behaviorism in the form espoused by Burger. Hence, despite economic behaviorism's influence on decisions that are primarily grounded upon other currents, particularly traditionalism, I cannot conclude that economic behaviorism contributed a fourth vote in favor of the convictions in *Carpenter*.

D. Paradigm Case Analysis

Three additional recognizable currents represent general approaches to interpreting statutes or administrative regulations more than they reflect any substantive positions about regulating insider trading by means of rule 10b-5. In this regard, they differ from idealism and economic behaviorism, and even traditionalism, when account is taken of the latter's bias against the expansion of federal law to matters traditionally within state law. I term the first of these modes of statutory interpretation "paradigm case analysis."

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[139] 463 U.S. at 658-59 (citations and footnotes omitted).

[140] *See infra* note 198.

To analyze on the basis of paradigm cases is a particular mode of deriving the legislative or administrative intent behind a statutory provision or administrative rule. First, the approach involves conceptualizing the dominant paradigm to which the provision was directed, i.e., what factual situation did the legislators have in mind when they drafted the particular provision? The second step is to adjudge how congruent with that paradigm are the actual facts of a given case. The closer the congruence, the more the adherent of paradigm case analysis is prepared to say the provision covers the case; the greater the dissimilarity between paradigm and facts, the more one following this interpretive approach would tend to conclude that the statutory or administrative provision does not cover the situation.

To illustrate paradigm case analysis, first consider this interpretive methodology in the opinions of Justice Stephens in *Landreth Timber Co. v. Landreth*[141] and *Gould v. Ruefenacht*,[142] two rule 10b-5 cases that did not concern insider trading. Then I will speculate about the position that Justice Stevens probably took in *Carpenter*. That speculation is, to some degree, informed by his concurring opinion in *Chiarella*.[143]

Landreth involved the purchase of a lumber business in the State of Washington by a Massachusetts attorney and other parties. The owner-seller was to remain as a consultant. The transaction was to be accomplished through a sale of 100 percent of the common stock of the corporation. The facts of *Gould* differ somewhat, in that only 50 percent of the corporate stock was to be sold, with the purchaser to take on some of the chores of the business while retaining his old job. But the similarities between the two cases seemingly dwarfed their differences. Although both acquisitions formally involved the sale of shares of stock, a more realistic depiction of each was that a business, or a large portion of a business, had been purchased and that the stock transfer, probably selected for tax or recording purposes, provided the means. In each situation the purchaser contended that misrepresentations had been made to him, and sued, *inter alia*, for damages pursuant to rule 10b-5.

The issue before the Court was whether these cases really involved the sale of "securities," a misrepresentation as to which would give rise to various remedies under the Securities Act of 1933 and the Securities Exchange Act of 1934, including relief under rule 10b-5. Under circumstances similar to the facts of *Landreth* and *Gould*, several Courts of Appeals had propounded a "sale of business" doctrine which would

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[141] 471 U.S. 681, 697 (1985) (Stevens, J., dissenting).
[142] 471 U.S. 701, 706 (1985) (Stevens, J., dissenting).
[143] Chiarella v. United States, 445 U.S. 222, 237 (1980).

exclude the reach of the Securities Acts to this kind of transaction.[144] The theory underlying this doctrine is, quite simply, that what is really being sold is a business, not securities. The transfer of securities is simply the means by which title to the business is transferred. Indeed, the Ninth Circuit denied relief to the purchasers in *Landreth* on this basis.[145]

The majority of the Supreme Court rejected the "sale of business" doctrine, holding that the purchasers did indeed have remedies under the federal Securities Acts. I will discuss shortly the current in which the majority's reasoning fits. Justice Stevens was the lone dissenter. In effect, he reasoned from two paradigms, two models of facts towards which the Securities Acts' remedies were directed. The first of these paradigms was "transactions in securities that are traded in a public market."[146] Such transactions were clearly covered by the reach of the Acts. But even if they were not, a second paradigm consisted of a transaction involving "an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction."[147] Although Justice Stevens did not as clearly state that this paradigm was intended to be covered by the Securities Acts' reach,[148] he did not have to confront

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[144]*See* King v. Winkler, 673 F.2d 342, 345 (11th Cir. 1982) ("[t]he 'economic realities' of the transaction indicate not a security transaction, but rather the sale and purchase of a business using stock merely as a method of vesting the . . . [purchaser] with total ownership"); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981) (sale of 100% of the stock, and assumption of control over marina); Chandler v. Kew, Inc., 691 F.2d 443 (10th Cir. 1977) (sale of liquor store by transfer of stock). *But see* Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983) (purchase of all shares of stock and assumption of managerial control of truck dealership held to be a securities transaction); Golden v. Garafalo, 678 F.2d 1139 (2nd Cir. 1982) (purchase of 100% of outstanding stock of corporation engaged in ticket brokerage business); Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979) (purchase of 50% of corporate stock and entry into corporation as executive vice-president).

[145]Landreth Timber Co. v. Landreth, 731 F.2d 1348 (9th Cir. 1984).

[146]Landreth Lumber Co. v. Landreth, 471 U.S. 681, 698 (1985) (Stevens, J., dissenting).

[147]*Id.* at 699.

[148]At one point in his dissent, Justice Stevens hints that only the first paradigm was intended to be covered by Congress:

> I am not persuaded, however, that Congress intended to cover negotiated transactions involving the sale of control of a business whose securities have never been offered or sold in any public market. In the latter cases, it is only a matter of interest to the parties whether the transaction takes the form of a sale of stock or a sale of assets, and the decision usually hinges on matters that are irrelevant to the federal securities laws such as tax liabilities, the assignability of Government licenses or other intangible assets, and the allocation of the accrued or unknown liabilities of the going concern.

Id. This formulation would seem to include the first paradigm, but exclude the second. Yet,

the legitimacy of applying the Acts to the second paradigm because the facts of *Landreth* and *Gould* differed substantially from both paradigms.

How might one who argues from paradigm cases confront the cutting edge of insider trading cases, such as *Carpenter*? One would first, as Justice Stevens did in the *Landreth* and *Gould* cases, construct a paradigm or paradigms to which rule 10b-5 is directed, and, second, measure in at least a rough way the degree of similarity between such paradigms and the facts of the given case. What would such paradigms concerning insider trading appear to be? The most clear-cut would consist of the corporate insider—officer, director or other employee having a fiduciary duty not to trade on the basis of inside information—who either purchases or sells stock to the plaintiff in the case without disclosing the inside information to the other party. Another paradigm, only one step removed from the first, would consist of a tippee from an insider, knowing that the insider was breaching his duty by disclosing such inside information to him, trading with another on the basis of such information.[149]

The facts of *Carpenter*, like those of *Chiarella*, fell within neither paradigm. Winans, the Wall Street Journal reporter, was neither an insider of the corporation whose stock was traded nor, presumably, a tippee of such insiders. Carpenter, a co-defendant with Winans and his lover, and Felis, another co-defendant, were tippees, but they were tippees from Winans alone.

Significantly, Justice Stevens concurred in *Chiarella*. In his concurrence, Stevens displayed unease with the extent to which the facts of *Chiarella* departed from traditional paradigms of liability. He explicitly rejected Chief Justice Burger's analysis that when Chiarella "bought securities in the open market, he violated . . . a duty to disclose owed to the sellers from whom he purchased target company stock."[150] Yet, Stevens did suggest, without himself adopting, a version of the misappropriation theory that the government later used to prosecute Winans and his tippees in *Carpenter*. He opined that "[t]he Court correctly [did] not address . . . whether the petitioner's breach of his duty of silence—a duty he unquestionably owed to his employer and to his employer's

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at another point, Justice Stevens stated:

> In short, I would hold that the antifraud provisions of the federal securities laws are inapplicable unless the transaction involves (i) the sale of a security that is traded in a public market; or (ii) an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction.

Id. This statement of the propriety of remedial relief under the Securities Acts would include facts falling within both paradigms.

[149] *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2nd Cir. 1974).

[150] Chiarella v. United States, 445 U.S. 222, 237 (1980) (Stevens, J., concurring).

customers—could give rise to criminal liability under Rule 10b-5.''[151] Stevens was not then prepared to adopt his own suggestion because, ''inasmuch as those companies [the tender offerors] would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, . . . it could also be argued that no actionable violation of Rule 10b-5 had occurred.''[152]

It is unclear how Justice Stevens voted in *Carpenter.* If Stevens would have reversed the convictions under rule 10b-5, the reason would have been that the facts of *Carpenter* differed materially from those paradigms to which rule 10b-5 is applied most comfortably. If, on the other hand, Stevens did vote to uphold the convictions on rule 10b-5 grounds, that vote would mean that he managed to dispel the doubts he had raised in *Chiarella.* He would, in effect, have constructed a third paradigm of rule 10b-5 liability: the party who steals information from one party and uses it to profit against another. Facts falling within this third paradigm could give rise to criminal liability, but not civil suits on the part of the sellers or purchasers of the securities.

E. Literalism

Another current that represents a theory of statutory interpretation is ''literalism.'' It has had a large impact on rule 10b-5 cases generally,[153] although thus far its influence on that subset of rule 10b-5 cases dealing with insider trading has been subtle. Among the justices whose opinions have evinced literalism are Justices O'Connor, Powell and arguably White.

For example, Justice Powell wrote the majority opinion in *Landreth* to which Justice Stevens dissented. Having reviewed the facts and procedural history of the case, Powell initiated his legal discussion with the axiom ''that '[t]he starting point in every case involving construction of a statute is the language itself.' ''[154] From axiomatic statement to holding

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[151] *Id.* at 238. Despite Justice Stevens' reservations, at least one prominent scholar (*see* Aldave, *supra* note 2) and the Second Circuit Court of Appeals (*see, e.g.*, Moss v. Morgan Stanley, 719 F.2d 5 (2d Cir. 1983)) have advocated or adopted, as the case may be, Stevens' suggested version of the misappropriation theory, which emphasizes a duty of silence owed to one's employer rather than any purported duty of disclosure owed to others (such as had been suggested by Chief Justice Burger).

[152] *Id.* One can sense Justice Stevens' struggle by his comment in a footnote at that point: ''the limitation on the right to recover pecuniary damages in a private action identified in *Blue Chip Stamp* is not necessarily coextensive with the limits of the rule itself.'' *Id.*

[153] *See* Conard, *supra* note 96, at 210-12.

[154] Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1984) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring)).

became a brief exercise: "the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts."[155] While Powell gave some consideration to statutory purpose, the reference to purpose seemed more in the nature of a rebuttal of those arguments tendered in support of "the sale of business" doctrine.

Two of Justice O'Connor's recent opinions in rule 10b-5 cases reflect the same paramountcy of language as an index of statutory intent. In *Randall v. Loftsgaarden*,[156] a 1986 case, the Supreme Court was confronted with the issue of whether tax benefits received by investors should be used to reduce their awards in actions to rescind the sale of limited partnership interests. The plaintiffs based their claims both on Section 12(2) of the Securities Act of 1933,[157] which explicitly grants a right of rescission for misleading statements or material omissions in a prospectus, and on rule 10b-5. The allegation in the case was that statements made in connection with the limited partnership interests were false,[158] and the project in which interests were sold in fact became bankrupt. While Section 12(2)'s right of rescission allows for recovery of "the consideration paid for such security with interest thereon," it also provides that "the amount of any income received thereon" is to be deducted from the recovery. The defendants argued that the plaintiffs had invested primarily for tax considerations, so that their out-of-pocket loss was but a miniscule percentage of the consideration they had tendered for their interests. The first part of Justice O'Connor's opinion thus concerned whether "any income received thereon" in section 12(2) should be construed to include tax benefits gained from the investment. Justice O'Connor answered this question in the negative, relying, as had Justice Powell in the *Landreth* case, almost exclusively on the "plain meaning" rule.[159]

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[155]*Landreth* at 687.

[156]106 S. Ct. 3143 (1986).

[157]15 U.S.C. § 77l(2) (1982).

[158]For example, it was alleged that the availability of financing, the terms of the land lease, and the manner and extent of the compensation for services rendered were mischaracterized. 106 S. Ct. at 3147.

[159]Justice O'Connor stated:

> Here, as in other contexts, the starting point in construing a statute is the language of the statute itself. . . . Moreover, "if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary 'to examine the additional considerations of "policy" . . . that may have influenced the lawmakers in their formulation of the statute.' " Section 12(2), we think, speaks with the clarity necessary to invoke this "plain language" canon . . . . [S]uch [tax] benefits cannot, under any reasonable definition, be termed "income."

106 S. Ct. at 3150 (citations omitted).

The rule 10b-5 claim for rescission could not be settled so easily by looking at the "plain meaning" of the language. Section 28(a) of the Securities Exchange Act, in fact, limits damages for causes of action brought under that Act to "actual damages,"[160] a phrase which, when taken in the vernacular, would seem to require that such matters as tax benefits be considered in any award. But with respect to the 10(b) claim, Justice O'Connor argued for the desirability of interpreting both section 12(2) and rule 10b-5 similarly with respect to rescissionary damages.[161] Significantly, recognizing that her resolution of the two issues would grant a windfall to the suing investors, Justice O'Connor laced both her section 12(2) and section 10(b) discussions with the idealist element of deterrence:

> The effect of allowing a tax benefit offset . . . [and] resulting diminution in the incentives for tax shelter promoters to comply with the federal securities laws would seriously impair the deterrent value of private rights of action, which, we have emphasized, "provides 'a most effective weapon in the enforcement' of the securities laws and are a 'necessary supplement to Commission action.' "[162]

Literalism also colored Justice O'Connor's recent majority opinion in *Shearson/American Express, Inc. v. McMahon*.[163] The case presented the issue of whether a provision in the agreement between a customer and her brokerage firm that all disputes shall be submitted to arbitration is binding even as to rule 10b-5 and RICO[164] claims. The customer's argument depended, in part, on the combination of sections 29(a) and 27 of the Securities Exchange Act. The former section declares void "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Act],"[165] while the latter section provides that "[t]he district courts of the United States . . . shall have

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[160]15 U.S.C. § 78bb(a) (1982).

[161]This is a mode of statutory construction I term, "textual structuralism." *See infra* text accompanying notes 170-83. Justice O'Connor stated:

> When section 28(a) was enacted section 12(2) stood as a conspicuous example of a rescissionary remedy, and we have found that Congress did not intend that a recovery in rescission under section 12(2) be reduced by tax benefits received. Accordingly, we think section 28(a) should not be read to compel a different result where rescissionary damages are obtained under section 10(b).

106 S. Ct. at 3153.

[162]*Id.* at 3154 (quoting Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985), which in turn quoted J.I. Case Co. v. Borak, 377 U.S. 426 (1964)).

[163]107 S. Ct. 2332 (1987).

[164]18 U.S.C. § 1961 *et seq.* (1982).

[165]15 U.S.C. § 78cc(a) (1982).

exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."[166] The plaintiff argued that in light of section 27, the agreement to arbitrate constituted a waiver in violation of section 29(a). But, again, Justice O'Connor made reference to "the statute's plain language," distinguishing a waiver of "compliance" of a substantive claim from a waiver of a right to a particular forum.[167] The plaintiff-customer also relied upon the idealist consideration that requiring submission of such disputes to arbitration would diminish the deterrent effect of such causes of action. In *Shearson/American Express*, unlike in *Randall*, however, Justice O'Connor seemed unmoved by this consideration.[168]

As this brief review of the literalist mode of construing statutes indicates, it is difficult to interpret literalism as a philosophy that necessarily favors or disfavors rule 10b-5 claims. In this regard, it differs sharply from the Court's idealism of the late sixties and early seventies and the traditionalism evinced by decisions in the later seventies, although Justice O'Connor, to support her opinion, does not aver to cite either idealist or traditionalist opinions to buttress her literalist interpretation. Nonetheless, despite this seeming "neutrality," it is more than likely that those disposed towards literalist interpretations would not have sustained the convictions in *Carpenter* on rule 10b-5 grounds. To an avowed literalist such as Justice O'Connor, the case against application of rule 10b-5 in *Carpenter* is, quite simply, that it would be an extension beyond existing Supreme Court jurisprudence not required by the statutory language. In Justice White's case, literalism as a judicial philosophy would have strengthened his traditionalist leanings and insured a decision not to sustain the convictions on the rule 10b-5 grounds. Furthermore, although Justice Powell no longer sits on the Court, the praise lavished upon him upon his retirement suggests that literalism has attained a legitimacy among many observers.[169]

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[166] *Id.* § 78aa.

[167] *Shearson/American Express*, 107 S. Ct. at 2343.

[168] Justice O'Connor is not alone in depending upon a "literalist" interpretation. Justice White, joined by Chief Justice Burger and then Justice Rehnquist showed sympathy for the same mode of interpretation in another, recent securities law case that did not concern rule 10b-5. *See* Lowe v. SEC, 472 U.S. 181, 211 (1985) (White, J., concurring).

[169] Such legitimacy is hardly justified. In many if not most cases the meaning of statutory language is hardly "plain"; reasonable people can and do disagree as to that meaning. *See* Murphy, *Old Maxims Never Die: The "Plain-Meaning Rule" and Statutory Interpretation in the "Modern" Federal Courts*, 75 Colum. L. Rev. 1299 (1975). In addition the literalist would seem to prefer to hide from the difficult policy judgments inherent in the cases coming before the Court, rather than own up to the fact that, whether overtly or covertly, the Court necessarily makes such judgments.

F. Textual Structuralism

Textual structuralism is an interpretive strategy that emphasizes the desirability of having different sections of the same statute, or related statutes and other bodies of law, be interpreted as a whole. The objective is that each provision, as interpreted, not only make sense in itself, but also logically and purposefully relate to other provisions of the relevant legal framework. As applied to rule 10b-5, this interpretive strategy calls for determining the rule's elements, contours and defenses in a way that promotes harmony rather than dissonance with other remedial sections of the Securities Act of 1933 and the Securities Exchange Act of 1934, other administrative regulations under those statutes, and the body of case law dealing with the fraudulent sale or purchase of securities.

We already have observed one example of the use of textual structuralism. In *Randall v. Loftsgaarden*,[170] Justice O'Connor argued, in part, that the plaintiffs' claims under rule 10b-5 should not be reduced by any tax benefits received because they were not to be so reduced under section 12(2) of the Securities Act of 1933.

Of all sitting justices, Justice Blackmun has been the strongest advocate for textual structuralism in rule 10b-5 cases. One of his most forceful pleas for textual structuralism appears in his dissent in *Aaron v. SEC*,[171] in which the majority held that the SEC, when suing for an injunction under rule 10b-5, is bound by the same scienter requirement as are private parties in a damage suit.[172] Blackmun "believe[d] [the majority's] most serious error may be a failure to appreciate the structural interrelationship among equitable remedies in the 1933 and 1934 Acts, and to accord that interrelationship proper weight in determining the substantive reach of the Commission's enforcement powers under § 17(a) and § 10(b)."[173] More specifically, Blackmun noted that the SEC is able to secure relief against the negligent representation of sellers under section 17(a) of the Securities Act of 1933, but, as a result of the majority's holding, unable to secure the same relief against negligent misrepresenting buyers under rule 10b-5. In his words, "the two statutes should operate in harmony."[174]

Similarly, when dissenting in *Shearson/American Express, Inc. v. McMahon*,[175] Justice Blackmun used the existence of longstanding precedent that claims under section 12(2) of the Securities Act of 1933 are

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[170]106 S. Ct. 3143 (1986). *See supra* notes 156-62 and accompanying text.

[171]446 U.S. 680, 713 (1980) (Blackmun, J., dissenting).

[172]*Id.* at 689-95. *See also supra* notes 90-95 and accompanying text.

[173]446 U.S. at 713.

[174]*Id.* at 715.

[175]107 S. Ct. 2332, 2346 (1987) (Blackmun, J., dissenting).

not arbitrable as strong support that rule 10b-5 claims should not be either.[176] In both of these cases, Blackmun, whose opinions were joined by Justices Marshall and Brennan, also used idealist arguments such as the need to protect the investing public. In *Aaron*, the idealist arguments seemed to support textual structuralism; in *Shearson/American Express*, textual structuralism supported a strongly argued idealist position.

Justice Blackmun's preference for structuralism as an interpretive strategy surely would have reinforced his preference for idealism as a substantive norm in *Carpenter* as well. To support this theory, I need only refer to his dissenting opinion in *Chiarella*.[177] Recall that the majority, per Justice Powell, reversed Chiarella's conviction because the government had not pleaded and proved a violation by Chiarella of any affirmative duty of disclosure owed to the sellers of the securities,[178] but that Chief Justice Burger, in dissent, would have upheld Chiarella's conviction based, in part, on Chiarella's misappropriation of information from his employer, the printing company, and his employer's customers.[179] Justice Blackmun, in contrast, dissented from the whole traditionalist notion that one need allege and prove violation of a duty. To Blackmun, even if Chiarella's employer had given him permission to trade on the basis of the information about tender offers he had received by virtue of his position as a printer, Chiarella still would have violated rule 10b-5.

Justice Blackmun's analysis focused on the position of the federal securities laws in the total structure of law relating to insider trading, and the specific position of section 10(b) in the structure of the federal securities laws. If, as did the majority, one imports into section 10(b) and rule 10b-5 a state-law derived fiduciary duty requirement, one "places the federal securities laws in the rearguard of . . . [a] movement"[180] that would allow for a greater number of instances in which investors at an informational disadvantage could recover. Instead, the purpose of the federal securities law is to be in the foreground, that is, "to ensure the

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[176] *Id. See also* Wilko v. Swan, 346 U.S. 427 (1953). Speaking for the majority, Justice O'Connor placed *Wilko*'s continuing validity in substantial doubt but did not explicitly overrule the case.

[177] Chiarella v. United States, 445 U.S. 222, 245 (1980) (Blackmun, J., dissenting).

[178] *See supra* text accompanying notes 111-19.

[179] Once having violated the duty of silence owed to his employer, Burger also intimated that Chiarella owed a duty of disclosure towards investors in the marketplace. *See supra* text accompanying notes 129-35. Other separate opinions included those of Justice Stevens (discussed *supra* notes 150-52 and accompanying text) and Justice Brennan, who agreed with Chief Justice Burger's theory that violation of a duty to Chiarella's employer would suffice but concurred with the majority because Burger's theory was not the one presented to the jury. 445 U.S. at 239 (Brennan, J., concurring).

[180] *Id.* at 248 (Blackmun, J., dissenting).

fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate."[181] Within the structure of the federal securities laws, section 10(b) was designed to be "an intentionally elastic 'catchall' provision."[182] Imposition of a fiduciary duty requirement undermines the ability of the section to fulfill that role within the structure of the securities laws. Hence, Justice Blackmun, dispensing with breach of a fiduciary duty as a precondition to rule 10b-5 liability, would have held "that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities."[183] Winans and his co-defendants engaged in a scheme to exploit the informational advantage Winans enjoyed as an author of the "Heard on the Street" column in the Wall Street Journal. The fact that Winans was not a traditional insider would hardly have mattered to Justice Blackmun. After all, rule 10b-5 as a "catch-all" provision within the remedial or enforcement structure of the securities acts may play its most important role precisely when the facts do not fit more traditional paradigms.

II. The Competing Currents: The Future

Certain metaphors, the linear and the cyclical, that are commonly used to describe events[184] do not aptly convey the use and force of the strands of thought that characterize the Supreme Court's rule 10b-5 jurisprudence. For example, the case law clearly does not evince a linear movement from point X to point Y. Even during the latter 1970's when traditionalism was strongest, some justices expressed an attachment to idealism. In the mid-1980's, idealism, traditionalism and literalism have all recurred in majority opinions. Nor should a cyclical metaphor be adopted, for we have not come full circle. Expressions of idealism in the latter 1980's do not go unchallenged as frequently as they did in the early 1970's. Idealism has recurred in majority opinions, but it has no monopoly on them.

Rather, a wave-like metaphor seems most appropriate—hence, the term, "competing currents." The currents come, recede and come again, not alone, but in competition with other currents. Sometimes, like ide-

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[181] *Id.*

[182] *Id.* at 246.

[183] *Id.* at 251. It is interesting to note that Blackmun is as disturbed by "structural" anomalies on a substantive level as with respect to statutory text. In both contexts, Blackmun seems to be asking the question, does the particular make sense in terms of the whole?

[184] *See, e.g.*, S. Gould, Time's Arrow, Time's Cycle (1987).

alism in the early seventies, traditionalism in the latter seventies and arguably literalism in today's opinions, they dominate or tend to dominate but do not exclude the appearance of other currents. At times a particular current first appears in a minority opinion—for example, economic behaviorism in Chief Justice Burger's dissenting opinion in *Chiarella*—only to resurface in the majority's opinion several years later. As I noted, at least some of Justice Powell's discussion in *Dirks* can be traced to Burger's discussion in *Chiarella*.[185]

Two of the factors that correlate positively with the appearance or even dominance of a current in the Court's opinions are the identity of that opinion's author and the time frame in which the case comes before the Court. True, the importance of these factors can be inflated. Justice Brennan, for example, most often appropriately characterized as an idealist,[186] has not been averse to espousing traditionalist views.[187] Justice O'Connor, a literalist, has buttressed her opinions with both idealism[188] and textual structuralism.[189] With the caveat, then, that the correlation between these factors and the strength of competing currents is frequently a weak one, what if anything can be said about the future course of the Supreme Court's jurisprudence in this area?

A number of personnel changes have occurred recently: Chief Justice Burger and Justice Powell have retired; Justice Rehnquist has been elevated to Chief Justice; and Justices Antonin Scalia and Anthony Kennedy have replaced Rehnquist and Powell as Associate Justices. In truth, very little is known about either Scalia's or Kennedy's views with respect to rule 10b-5 and insider trading.[190] Nonetheless, we can speculate that, collectively, these changes and others that may soon come will strengthen traditionalism and literalism and weaken idealism and textual structuralism. Chief Justice Rehnquist is one of the foremost traditionalists on the Court. His ability to lead the Court by, among other things, assigning cases to particular justices could influence case law development over time. Scalia's writings show a closer affinity to traditionalism or economic behaviorism than to any form of idealism.[191]

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[185]*See supra* text accompanying note 139.

[186]For example, if Justice Brennan is assigned to write the Court's opinion, as he was in Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985), we are likely to see an idealist expression of rule 10b-5, even if most justices join in that opinion.

[187]Cort v. Ash, 422 U.S. 66 (1975). *See supra* text accompanying notes 67-73.

[188]Randall v. Loftsgaarden, 478 U.S. 647 (1986). *See supra* notes 156-62 and accompanying text.

[189]*See supra* notes 163-68 and accompanying text.

[190]Kennedy has shown some sympathy towards implied causes of action. *See, e.g.*, Texas Partners v. Conrock Co., 685 F.2d 1116 (9th Cir. 1982) (reversing the district court's grant of summary judgment for defendants in an alleged proxy violation case).

[191]*See* Scalia, *Morality, Pragmatism and the Legal Order*, 9 HARV. J.L. & PUB. POL'Y

All three of the idealist Justices—Blackmun, Brennan and Marshall—reportedly have suffered physical setbacks in recent years that may induce the retirement of one or all of them. If Blackmun retires, textual structuralism will also lose its foremost enunciator. In contrast, at least one outspoken literalists, Justice O'Connor, seems likely to remain on the Court for some time.

At the same time, it is at least conceivable that current trends outside the Court will induce some movement in the direction of idealism, somewhat neutralizing the personnel changes. Justices are politicians of a kind, even though they are not elected. The Court's legitimacy ultimately depends upon the acceptance of its opinions not only as legal documents, but also as symbols of what is correct and incorrect. It may be that the traditionalism of the Court in the latter 1970's presaged the political conservatism that was demonstrated at the polls only several years later. But, in contrast to the latter seventies, political opinion today seems different.

Reports of certain recent insider trading cases reached a wide audience, and prosecution of such trading seems very popular.[192] Certain program trading activities, such as index arbitrage and portfolio insurance, practiced by a relatively small number of sophisticated institutional traders, generally are considered to have accelerated the decline in the stock market that resulted in its collapse in October, 1987.[193] The strong trend towards the passage of state anti-takeover legislation[194] is consistent with a popular discontent with financial manipulations that seem to make money for a few at the expense of others,[195] regardless of the validity of that popular perception when applied to corporate takeovers and restructurings. Significantly, the Supreme Court encouraged the trend by sustaining the present generation of such legislation,[196] in contrast to

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123 (1986). Scalia, without referring to rule 10b-5, seems to reject the necessary fusion of law and morality which underlies at least some of the idealist expressions.

[192]*See, e.g.*, Wall St. J., Feb. 13, 1987, at 1, col. 6 (details of arrests of Richard Wigton of Kidder Peabody and Robert Freeman of Goldman Sachs for swapping information about impending takeovers).

[193]*See, e.g.*, N.Y. Times, Feb. 3, 1988, at D4, col. 1 (excerpts from S.E.C. Report on Factors in October Stock Market Plunge); N.Y. Times, Jan. 11, 1988, at D8, col. 1 (analysis of Brady Commission report on stock market plunge).

[194]The latest evidence of the trend is the enactment by Delaware of HB 396. *See* 20 Sec. Reg. & L. Rep. (BNA), 209 (Feb. 5, 1988). Delaware had previously resisted the trend.

[195]This is not to say that such anti-takeover legislation results from such popular discontent. Rather, evidence suggests that lawmakers are reacting to demands from particular constituents such as corporations incorporated and/or operating within the borders of their states. *See* Romano, *The Political Economy of Takeover Statutes*, 73 Va. L. Rev. 111, 135-36 (1987). But the popular perception might indicate why there is little if any opposition to such legislation on the part of others.

[196]*See* CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637 (1987).

its earlier decision about state legislation that also sought to limit take-overs.[197] With respect to rule 10b-5 jurisprudence, therefore, we can suspect that the Court will not totally shun idealism, with its nexus between law and ethics, until and unless the public mood again shifts.

With personnel moving in one direction and the popular mood in another, the currents we have identified will continue to compete against each other. For the foreseeable future, none is likely to dominate the Supreme Court's rule 10b-5 jurisprudence, although the majority opinion in any particular case will reflect the predilection of the opinion's author for one of the currents. In light of the eight member Court sitting at the time of the decision, the four-four split in *Carpenter* was not a surprise. Nor will be the split decisions, whether five to four or six to three,[198] that are likely to follow.

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[197]*See* Edgar v. MITE Corp., 457 U.S. 624 (1982).

[198]For example, the Supreme Court recently split 4-2 in Basic Inc. v. Levinson, 108 S. Ct. 978 (1988), in which it faced, *inter alia*, the issue of whether to accept the "fraud on the market" theory in rule 10b-5 cases. That theory would allow plaintiffs who are sellers or buyers of stock traded in market transactions to recover regardless of whether they can prove their own particular reliance on a misleading statement or omission. The presumption (which, depending upon one's version of the theory, might be rebuttable) is that the misleading statement has affected the market as a whole, and hence the plaintiffs can be presumed to have relied whether or not they actually read or heard of the statement or omission. In *Basic Inc.*, the corporation issued three press releases over a fourteen month period denying any merger negotiations at a time when such negotiations were proceeding, although no deal had then been struck. The plaintiff brought a class action against the corporation and its directors. The class was defined as those who had sold the corporation's securities during the fourteen month period. Justice Blackmun wrote the opinion for the majority, in which Justices Brennan, Marshall and Stevens joined. Justice White wrote an opinion, concurring in part and dissenting in part, joined by Justice O'Connor. White dissented from the majority's acceptance of the fraud on the market theory. Chief Justice Rehnquist and Justices Scalia and Kennedy took no part in the consideration of the case.

The split in *Basic Inc. v. Levinson* was quite predictable, although the absence of three justices might have skewed the vote somewhat. Justices Blackmun, Brennan and Marshall were pursuing their idealist goal, and Justice Stevens joined because the facts of *Basic Inc.* fell within his dominant paradigm for the application of rule 10b-5. Justice White dissented on traditionalist grounds, and the literalism of Justice O'Connor, a current that Justice White also shares, dictated an alliance with traditionalism rather than idealism in the circumstances of the case.

To Justice Blackmun, one if not the main reason for adopting the fraud on the market theory was that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones." *Id* at 989. That resolution would discourage the initiation of such rule 10b-5 litigation. Instead, Justice Blackmun was quite open in the fact that his goal was to "facilitat[e] . . . Rule 10b-5 litigation." *Id.* at 990. As an idealist, Justice Blackmun was undaunted by the fact that the state law of fraud or deceit included a reliance element: "Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentations claims, . . . and are in part designed

to add to the protection provided investors by the common law, . . ." *Id.* at 990 n.22. Significantly, Justice Blackmun laced his opinion with references to such idealist icons as *Affiliated Ute Citizens v. United States* and *Mills v. Electric Auto-Lite Co. See, e.g., id.* at 989-90.

Justice Blackmun also added language to his opinion that would appeal to Justice Stevens' emphasis upon paradigm cases. Recall that Justice Stevens dissented in *Landreth Timber Co. v. Landreth* and *Gould v. Ruefenacht* primarily on the ground that the facts of those cases differed too substantially from the prime paradigm case to which the Securities Acts were directed: the trading of securities in market transactions. For the benefit of Justice Stevens (and obviously because it also fit with Justice Blackmun's idealist agenda), Justice Blackmun made reference to Justice Stevens' paradigm: "The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences." *Id.*

Justice Blackmun also supported his decision by reference to economic theory supporting the "premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.* at 991. Justice Blackmun's use of economic theory demonstrates that while economic behaviorism does not dominate the thinking of any present sitting justice, with the possible exception of Scalia, this current has had some influence on other justices. *See supra* text accompanying notes 122-40.

To a traditionalist like Justice White, at least two aspects of Justice Blackmun's opinion were quite objectionable. First and most importantly, it was anathema to White to develop rule 10b-5 along lines that departed substantially from state law elements of fraud. In Justice White's own words, "In general, the case law developed in this Court with respect to § 10(b) and Rule 10b-5 has been based on doctrines with which we, as judges, are familiar: common-law doctrines of fraud and deceit." 108 S. Ct. at 994. In addition, Justice White, unlike Justice Blackmun, voiced the concern of traditionalists with the equities, or more accurately, the lack thereof, of the suing plaintiffs: "I suspect that all too often the majority's rule will 'lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.' . . . This Court and others have previously recognized that 'inexorably broadening . . . the class of plaintiff[s] who may sue in this area of the law will ultimately result in more harm than good.' " *Id.* Justice White cited his own traditionalist opinion in *Sante Fe Industries, Inc. v. Green* for the development of rule 10b-5 along the lines of the state law of fraud, *id.*, and such other traditionalist touchstones as *Blue Chip Stamps v. Manor Drug Stores* and *Ernst & Ernst v. Hochfelder* to support his suggestion that too much litigation would be produced by the majority's decision. *Id.* at 999.

Justice O'Connor's attachment to literalism led her to support Justice White's traditionalism. Nothing in the statutory language supported the majority's adoption of the fraud on the market theory.

The absence of Chief Justice Rehnquist and Justices Scalia and Kennedy obviously changed the numbers in the majority and the dissent, but probably did not change the result. Justice Rehnquist would probably have dissented on traditionalist grounds, and it is unknown whether Justice Kennedy would have sided with idealism or traditionalism on the issue raised. But Justice Scalia would have added a fifth vote for the majority's decision, not because of any agreement with Justice Blackmun's idealism, but because of the majority's adoption of a theory grounded in economic behaviorism. In at least one prominent case outside the securities law context, Justice Scalia has explicitly pledged his allegience to economic theory as the determinant of rights under federal law. *See* Boyle v. United Technologies Corp., 108

S. Ct. 2510 (1988) (manufacturer of helicopter that crashed held not susceptible to suit by father of deceased Marine pilot because, *inter alia*, "[t]he imposition of liability on Government contractors will directly affect the terms of the Government contracts: either the contractor will decline to manufacture the design specified by the Government, or it will raise its price"). *Id.* at 2515. The only question about whether Justice Scalia would have concurred with the idealist majority in *Basics Inc. v. Levinson* is whether his espousal of economic behaviorism will carry over to contexts where the plaintiff rather than the defendant is aided by the application of economic theory.

Disclaimer of Joint Tenancy Interest—When Does the Nine-Month Time Limit in I.R.C. Section 2518 Begin to Run?

I. Introduction

In *Kennedy v. Commissioner*,[1] Frank Kennedy acquired 160 acres of Illinois farmland in 1953 and titled the property as joint tenants with right of survivorship between his wife and himself. Frank died in 1978. Within nine months of his death, his wife disclaimed the interest she had acquired in the farm by surviving Frank.[2] Not only in this case, but in all cases dealing with the disclaimer of joint tenancy interests under section 2518[3] of the Internal Revenue Code, the key issue is at what point did the transfer that created Mrs. Kennedy's interest occur—at the creation of the tenancy or at the death of her husband. In *Kennedy* the Seventh Circuit Court of Appeals held that, because of her husband's right to partition, the transfer of the survivorship interest took place at his death and Mrs. Kennedy's disclaimer was a qualified disclaimer (one that avoids the imposition of tax).[4] This holding is in direct conflict with the interpretative Treasury Regulation Section 25.2518-2(c)(4)(i) that was enacted in August of 1986 just shortly before the *Kennedy* decision.[5] The regulation states, "an interest or any portion of an interest in a joint tenancy . . . must be made no later than 9 months after the transfer creating the tenancy."[6] The *Kennedy* court held the regulation was inconsistent with the other regulations applicable to section 2518 disclaimers and chose not to apply it.[7]

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[1]804 F.2d 1332 (7th Cir. 1986).

[2]*Id.* at 1333.

[3]All section numbers used in this Note refer to the *Internal Revenue Code of 1986* as amended unless otherwise noted; *see infra* note 31 for language of I.R.C. § 2518 (1987).

[4]*Kennedy*, 804 F.2d at 1336. The court compared the survivorship right to that of a general power of appointment and found the regulations treatment of joint tenancy inconsistent with that of general power of appointment in Treasury Regulation Section 25.2518-2(c)(3). *See infra* text accompanying notes 162-81.

[5]Treas. Reg. § 25.2518-2(c)(4)(i) (1986); *see infra* text accompanying note 52 for language of regulation. A difference exists between interpretative regulations and legislative regulations, interpretative regulations having less weight. For full discussion *see infra* text accompanying notes 183-87.

[6]Treas. Reg. § 25.2518-2(c)(4)(i) (1986); *see infra* text accompanying note 52 for language of regulation.

[7]*Kennedy*, 804 F.2d at 1335-36.

This Note will show that the *Kennedy* decision recognizes the reality of modern joint tenancy property and is more in line with the Congressional intent behind section 2518 than the Treasury Regulation Section 25.2518-2(c)(4)(i).[8] The Congressional intent behind section 2518 is that the time period in the statute should run from the taxable transfer of the interest,[9] and that section 2518 was to provide a uniform federal disclaimer law which was not dependent on state or local law.[10] The *Kennedy* decision is also more in line with the broader Congressional intent of fairness behind the tax law that similarly situated taxpayers be treated the same,[11] and with other recent tax legislation that has eased the estate tax burden on farm families when passing their estates on to the next generation.[12]

The *Kennedy* court is the first court of appeals to address the issue of from which transfer the nine-month time period in Section 2518 begins to run.[13] The Eighth Circuit Court of Appeals, however, will be facing this issue in the spring of 1988 in *McDonald v. Commissioner.*[14] *McDonald* will give the Eighth Circuit a chance to side with the Seventh Circuit in holding against the Internal Revenue Service's (Service or IRS) interpretation of the Treasury regulation. However, if the Eighth Circuit chooses to accept the Service's interpretation, there will be a split between two circuits, and the United States Supreme Court may take the opportunity to decide the conflict.

Resolution of this conflict is important to the taxpayer because it can have a large impact on the amount of estate tax couples holding property as joint tenants will incur in passing their estates to the next generation. This impact will be demonstrated by example below.

II. The Relevancy of Allowing Disclaimer of the Survivorship Interest in Joint Tenancy Property Under Present Tax Law

The Economic Recovery Tax Act of 1981[15] dramatically changed the gift and estate tax consequences between spouses. The Act provided for an unlimited marital deduction, thus preventing any tax on any inter

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[8]Treas. Reg. § 25.2518-2(c)(4)(i) (1986); *see infra* text accompanying note 52 for language of regulation.

[9]*See infra* text accompanying notes 80-93.

[10]*See infra* text accompanying notes 94-107.

[11]*See infra* text accompanying notes 108-14.

[12]*See infra* text accompanying notes 115-16.

[13]Kennedy v. Commissioner, 804 F.2d 1332, 1333 (7th Cir. 1986).

[14]89 T.C. 293 (1987). *See infra* notes 192-98 and accompanying text.

[15]Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

vivos gift or bequest at death to one's spouse.[16] By increasing the unified gift and estate tax credit to $192,800, it also increased to $600,000 the amount that any one taxpayer can give during his life and pass at death without being subject to a tax.[17] Because of these changes, in estates where the combined assets in a husband and wife's estate are less than $600,000, the disclaimers of joint tenancy property would not affect the gift or estate tax paid by the couple.

In estates larger than $600,000, however, the right to disclaim the survivorship interest in jointly held property can have a major impact on the amount of estate tax a couple holding property as joint tenants will incur in passing their estates to the next generation. This can best be explained by illustration. Disclaimer of joint tenancy interests will be relevant in most states involving spousal property because of assets such as stocks, bonds, and personal homes which many times are owned as joint tenants with right of survivorship. However, the issue may be particularly important to agricultural estates, such as in *Kennedy*, where land held as joint tenants make up the major portion of the assets. Therefore, the following examples deal with land held by farm couples.

In both examples the couple's only property is assumed to be farmland worth 1.2 million dollars.[18] It is further assumed, for the sake of simplicity, that the deductions for debts, estate administration expenses, state death taxes and other expenses are zero. The annual rate of appreciation in land value is also assumed to be zero.

The first example shows the tax consequences when the couple own the land as joint tenants with right of survivorship and the Service's position on disclaiming of joint tenancy property is followed. The second example shows the tax consequences under similar ownership when the disclaimer of the survivorship interest is allowed as it was in *Kennedy*. Both examples illustrate the total federal estate taxes paid by husband and wife before the property is finally distributed to the next generation, assuming one spouse survives the other by at least ten years.

EXAMPLE 1. Disclaimer of Survivorship Interest Disallowed

Husband dies in 1987 and wife is not allowed to disclaim the survivorship interest in the farm, so husband's undivided one-half interest of $600,000 passes to her. Wife dies ten years later and the farmland, worth $1,200,000,

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[16]I.R.C. §§ 2056(a), 2523(a) (1987). Section 2056 allows all qualified property that will pass to the decedent's spouse to be deducted from the decedent's gross estate, thereby escaping federal estate taxes. Section 2523 provides that a donor may deduct all qualified gifts made to a spouse when computing taxable gifts, thereby escaping federal gift tax.

[17]I.R.C. § 2010(a), (b) (1987). The unified credit was phased-in. For decedents dying in 1987 and thereafter, the credit will be $192,800 (sheltering $600,000).

[18]The example is not unrealistic even with today's depressed land prices; it could represent a 1000 acre Illinois or Indiana farm worth $1200 per acre.

less the amount sold to pay husband's estate taxes, passes to heirs. The tax impacts are as follows:

Estate Tax Paid by Husband's Estate	$ -0-[19]
Estate Tax Paid by Wife's Estate	$ 235,000[20]
Combined Estate Tax Paid by Husband and Wife	$ 235,000

EXAMPLE 2. Disclaimer of Survivorship Interest Allowed

Husband dies in 1987 and wife is allowed to disclaim the survivorship interest in the farm. The husband's one-half undivided interest, worth $600,000 less the amount sold to pay death taxes, passes to heirs. Wife dies ten years later and her one-half undivided interest, worth $600,000 less the amount sold to pay her estate tax, passes to heirs. The tax impacts are as follows:

Estate Tax Paid by Husband's Estate	$ -0-[21]
Estate Tax Paid by Wife's Estate	$ -0-[22]
Combined Estate Tax Paid by Husband and Wife	-0-

With a combined estate of $1,200,000, disallowing the disclaimer of the survivorship interest results in a $235,000 higher tax liability. A

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[19]Husband's gross estate under I.R.C. § 2040(b) (1987) will be one-half the value of the joint tenancy property or, $600,000. Without disclaimer, husband's entire interest of $600,000 will be treated for tax purposes as if it passes to the surviving spouse.

However, under the marital deduction of I.R.C. § 2040(b) (1987) the entire $600,000 interest will qualify for the marital deduction and escape federal estate tax.

Gross Estate of Husband	$600,000
Marital Deduction	$600,000
Taxable Estate	$ -0-
Tax Payable upon Death of Husband	$ -0-

[20]Upon the death of the wife ten years later, her gross estate will total $1,200,000, the original value of the farmland. There is no allowable marital deduction, making the taxable estate worth $1,200,000.

The tentative tax of I.R.C. § 2001(c)(1) (1987) for a $1,200,000 estate equals $427,800.

The unified credit for decedents dying in 1987 will be $192,800. I.R.C. § 2010 (1987). The tax payable upon her death will then be $235,000.

Gross Estate of Wife	$1,200,000
Marital Deduction	-0-
Taxable Estate	$1,200,000
Tentative Tax	$ 427,800
Unified Credit	$ (192,800)
Tax Payable upon Death of Wife	$ 235,000

[21]The tentative tax on a $600,000 gross estate is $192,800. I.R.C. § 2001(c)(1) (1987). The amount is then reduced by the $192,800 unified credit applicable for decedents dying in 1987. I.R.C. § 2010 (1987). The result is a net tax of $-0-.

[22]The tentative tax on wife's $600,000 gross estate is $192,800. I.R.C. § 2001(c)(1) (1987). The amount is then reduced by the $192,800 unified credit applicable for decedents dying after 1987. I.R.C. § 2010 (1987). The result is a net tax of $-0-.

couple loses the benefit of the first spouse's unified credit[23] and incurs a higher effective tax rate because the value of the entire tenancy is taxed in the surviving joint tenant's gross estate.[24] Because the agricultural sector has been preoccupied with the current economic problems,[25] farm-couples may find, at the death of one spouse, that they have not done sufficient estate planning to ensure that their land and businesses can be passed on to the next generation with a minimum of estate tax. The ability to make a qualified disclaimer of a joint tenancy survivorship interest at the death of the first spouse, as in *Kennedy*, could be used as an effective post-mortem estate planning tool to help alleviate the tax burden of passing the estate on to the next generation and to avoid a possible forced sale of family property to pay estate taxes. To better understand the disclaimer issues raised by *Kennedy*, at this point a consideration of the development of federal disclaimer law is in order.

III. Background

A. *Brief Background on Federal Disclaimer Law*

Prior to the Tax Reform Act of 1976 (TRA 1976), the tax consequences of disclaimers were governed by section 2511, particularly Treasury Regulation Section 25.2511-1(c).[26] This regulation still governs disclaimers for interests created prior to 1977.[27] To be an effective

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[23]*See supra* note 19-22 and accompanying text.

[24]*Id.*

[25]Unlike the 1970's when the agricultural community was experiencing tremendous land value increases along with high commodity prices and estate planning was a major concern, the 1980's have brought decreases in land value of almost fifty percent as well as lower commodity prices. Farmers have become much more concerned with holding on to what they have and less concerned with proper estate planning.

[26]Treas. Reg. § 25.2511-1(c) (as amended in 1986) provides in pertinent part:

> [W]here the law governing the administration of the decedent's estate gives a beneficiary . . . a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent, . . . a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer . . . . Where the local law does not permit such a refusal, any disposition . . . constitutes the making of a gift.

For further explanation of prior TRA of 1976 disclaimer law and the changes made by the TRA of 1986, see Morris, *Disclaiming Joint Interests: One New Trick and No Longer a Dog?*, 1983 Ariz. St. L.J. 45, 58-62 (1983); Schain, *The Effective Disclaimer*, 34 Cath. U.L. Rev. 19, 20-25 (1984).

[27]Since I.R.C. § 2518 was enacted prospectively, § 2511 still applies to all interests created prior to January 1, 1977. Section 2518 of the Code applies to all interests created after December 31, 1976, while the ERTA amendment to the section can only be applied to disclaimers of interests created after December 31, 1981.

disclaimer under Treasury Regulation Section 25.2511-1(c), the refusal to accept must (1) be unequivocal, (2) be effective under local law, (3) occur before there is an acceptance, and (4) occur within a reasonable time.[28]

Due to its reliance on local law, Treasury Regulation Section 25.2511-1(c) raised several problems with the disparate treatment of federal disclaimers among the states.[29] What constituted a "reasonable time" under the regulation also created some confusion among the courts.[30] In an effort to resolve these issues, Congress enacted section 2518[31] to

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[28]Treas. Reg. § 25.2511-1(c) (as amended in 1986). *See supra* note 26 for language of regulation.

[29]*See* Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir.), *cert. denied*, 344 U.S. 836 (1952); *but see* Brown v. Routzahn, 63 F.2d 914 (6th Cir. 1933). For a discussion of these cases and their disparate treatment of disclaimers under their respective state law, see Morris, *supra* note 26, at 59; *see also* Schain, *supra* note 26, at 21-22.

[30]*See* Morris, *supra* note 26, at 59-60; Schain, *supra* note 26, at 23-25.

[31]I.R.C. § 2518 (1987) provides as follows:

> (a) GENERAL RULE.—For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.
>
> (b) QUALIFIED DISCLAIMER DEFINED.—For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if—
>
> (1) such refusal is in writing,
>
> (2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—
>
> (A) the date on which the transfer creating the interest in such person is made, or
>
> (B) the day on which such person attains age 21,
>
> (3) such person has not accepted the interest or any of its benefits, and
>
> (4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—
>
> (A) to the spouse of the decedent, or
>
> (B) to a person other than the person making the disclaimer.
>
> (c) OTHER RULES.—For purposes of subsection (a)—
>
> (1) DISCLAIMER OF UNDIVIDED PORTION OF INTEREST.—A disclaimer with respect to an undivided portion of an interest which meets the requirements of the preceding sentence shall be treated as a qualified disclaimer of such portion of the interest.
>
> (2) POWERS.—A power with respect to property shall be treated as an interest in such property.
>
> (3) CERTAIN TRANSFERS TREATED AS DISCLAIMERS.—A written transfer of the transferor's entire interest in the property—
>
> (A) which meets requirements similar to the requirements of par-

create uniformity with respect to the taxation of disclaimers for transfers after 1977.[32]

To be a qualified disclaimer under section 2518, similar to section 2511, the disclaimer must be an "irrevocable and unqualified refusal . . . to accept an interest in property."[33] Section 2518 also retains the requirement that the disclaiming party must not have accepted any benefits of the interest.[34] However, distinctions can be made between the two in that section 2518 added a requirement that the disclaimer be in writing,[35] and instituted a fixed nine-month time period to replace the "reasonable time" requirement of section 2511.[36] Also, unlike under section 2511, the nine-month time period under section 2518 runs from the creation of the interest regardless of whether the prospective disclaimant had knowledge of its existence.[37]

One of the most significant distinctions was Congress' intent not to have section 2518 depend on local law. This was demonstrated by the Congressional reports concerning the enactment of section 2518,[38] the absence of the language requiring compliance with local law in section 2518,[39] and Congress' amendment to section 2518 in the ERTA of 1981 by the addition of subsection c(3) to further alleviate dependency on local law.[40]

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agraphs (2) and (3) of subsection (b), and

(B) which is to a person or persons who would have received the property had the transferor made a qualified disclaimer (within the meaning of subsection (b)), shall be treated as a qualified disclaimer.

[32]*See* H.R. Rep. No. 1380, 94th Cong., 2d Sess. 66-67, *reprinted in* 1976 U.S. Code Cong. & Admin. News 3356, 3420-21 [hereinafter H.R. Rep. No. 1380].

[33]I.R.C. § 2518(b) (1987). *See supra* note 31 for text of the statute.

[34]*Id.* § 2518(b)(3). *See supra* note 31 for text of the statute.

[35]*Id.* § 2518(b)(1). *See supra* note 31 for text of the statute.

[36]*Id.* § 2518(b)(2). *See supra* note 31 for text of the statute. Moreover, if the disclaimant is a minor at the time the interest was created, he or she can defer the disclaimer decision until nine months after reaching 21 years of age. *Id.* § 2518(b)(2)(B).

[37]This result is mandated by the statute itself, which does not make a reference to the prospective disclaimant's actual knowledge of the existence of the instrument creating the disclaimed interest. *See* I.R.C. § 2518(b)(2)(A) (1987).

[38]*See* H.R. Rep. No. 1380, *supra* note 32, at 66-67.

[39]*See supra* note 31 and accompanying text.

[40]I.R.C. § 2518(c)(3) (1987). *See supra* note 31 for text of the statute. This amendment is effective only for disclaimers of interests transferred after 1981. Congress' intent was to finally devise a uniform standard for federal disclaimers totally independent from state law. S. Rep. No. 144, 97th Cong., 1st Sess. 142, *reprinted in* 1981 U.S. Code Cong. & Admin. News 108, 241-42 [hereinafter S. Rep. No. 144]. The Senate report provides that:

> Prior to the enactment of section 2518, the effect of a disclaimer, for Federal estate and gift tax purposes, depended on its validity under the applicable local law. When Congress enacted section 2518, it intended to create a uniform Federal

B. *IRS's Application of Section 2518 to Joint Tenancy Property*

1. Proposed Regulation Section 25.2518-2(d)(3).—Prior to enacting Treasury regulations for section 2518 in 1986,[41] the Service's position in applying section 2518 to joint tenancy property was reflected in its proposed regulation section 25.2518-2(d)(3). The regulation provided:

> To have a qualified disclaimer under section 2518 in the case of an interest in a joint tenancy (other than a revocable joint tenancy, such as a revocable joint bank account) or a tenancy by the entirety, the disclaimer—
>
> (i) Must be made with respect to the entire interest in property which is the subject of the tenancy,
> (ii) Must be made within 9 months of the creation of the tenancy, and
> (iii) Must meet each of the remaining requirements enumerated in section 2518(b).[42]

The premise upon which the proposed regulation is based is expounded upon in a private letter ruling concerning a surviving spouse's disclaimer of her deceased husband's interest in the couple's personal residence within nine months of his death in 1979.[43] The residence had been acquired in 1963 with title in the name of both as joint tenants with right of survivorship. The Service's position was that the disclaimer was invalid.[44] The Service adopted the view of the Oklahoma Supreme Court[45] in stating that, under Oklahoma law, the transfer took place at the creation of the tenancy because the husband had not transferred any interest in the jointly held property at his death.[46]

> standard so that a disclaimer would be effective for Federal . . . purposes whether or not valid under local law.
>
> Under section 2518, however, because the disclaimer must be effective to divest the disclaimant of ownership, and pass the interest without direction on the part of the [disclaimant], the disclaimer must still satisfy local law. Because applicable law varies from State to State, there is still no uniformity.
>
> The committee believes that a disclaimant should be able to perfect an otherwise valid disclaimer by directing that the interest pass to the person who would have received the property had the refusal been effective under local law.

See infra notes 99-100 and accompanying text for a discussion of the ERTA amendment in 1981. *See also infra* notes 104-07 and accompanying text for a general discussion of nonuniform treatment of Federal disclaimers.

[41] 51 Fed. Reg. 28,366 (1986).

[42] Prop. Treas. Reg. § 25.2518-2(d)(3), 45 Fed. Reg. 48,922, 48,927 (1980).

[43] Priv. Ltr. Rul. 81-400-11 (June 29, 1981).

[44] *Id.*

[45] Clovis v. Clovis, 460 P.2d 878 (Ok. 1969).

[46] Priv. Ltr. Rul. 81-400-11 (June 29, 1981).

The Service explained its position by using the language of the Oklahoma court that creation of a joint tenancy in property establishes a present estate in which both joint tenants are seised of the whole. Unity of time, title, interest, and possession are requisites for creation, with the principle characteristic of the estate created being the right of survivorship. Under this position, the right of survivorship does not pass anything from a deceased joint tenant to the survivor because, "by the very nature of joint tenancy[,] [t]itle of the joint tenant who dies first terminates at death and vests *eo instanti* in the survivor. Both cotenants being seised of the whole, the survivor's estate simply is a continuation, or extension, of the surviving tenant's existing estate."[47] The Service adopted the Oklahoma court's opinion that absent severance of the tenancy during the life of both tenants, a joint tenancy simply creates a present estate which assures the survivor joint tenant absolute ownership of the whole subject matter of the joint tenancy.[48]

The Service's premise raises issues with regard to the application of the nine-month time requirement and the acceptance of prior benefit provision under the statute. Under the Service's position the nine-month time period will begin to run at the creation of the tenancy, because under the Service's premise no transfer takes place at death; rather, transfer of all interest in the property, including the survivorship interest, takes place at creation.

As to acceptance of prior benefits, under its original premise, "if one joint tenant accepts any benefits from any part or portion of the property subject to the joint tenancy, that joint tenant has accepted benefits from the whole of the jointly owned property."[49] Because benefits have been accepted from the entire jointly owned property, an attempted disclaimer of any part of the jointly owned property will not be a qualified disclaimer.[50]

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[47]Priv. Ltr. Rul. 81-400-11 (June 29, 1981), quoting Clovis v. Clovis, 460 P.2d 878, 881 (Ok. 1969). *See generally* Morris, *supra* note 26, at 62-65; Uchtmann, *Disclaimers of Joint Tenancy Interests Revisited*, 18 Creighton L. Rev. 333, 337-44 (1985), for a further discussion of the IRS's position on disclaimers of joint tenancy property.

[48]Priv. Ltr. Rul. 81-400-11 (June 29, 1981).

[49]Uchtmann, *supra* note 47, at 339.

[50]*Id.* at 339 n.27, reads in part:

> I.R.S. Letter Ruls. 79-400-62, July 10, 1979 (acceptance based upon entering into a contract for sale); 79-120-49, Nov. 30, 1978 (accepting dividends from jointly-held corporate stock subsequent to its purchase and prior to disclaimer); 79-110-05, Nov. 29, 1978 (mere acquiescence in the establishment of joint tenancies of certificates of deposit and bank account); 78-290-08, April 14, 1978 (proceeds of jointly-owned maturities and securities deposited into joint checking account from which household and normal living expenses were paid).

The IRS later changed its position on the acceptance of benefits when it enacted Treasury regulations for section 2518. *See infra* text accompanying notes 57-58.

2. Enactment of Treasury Regulations for Section 2518.—The language of the enacted Regulation Section 25.2518-2(c)(4)(i) specifically concerning jointly held property differs in several respects from that of its predecessor, the proposed regulation 25.2518-2(d)(3).[51] The enacted regulation reads as follows:

> In general. Except as otherwise provided in paragraph (c)(4)(ii) of this section, a qualified disclaimer under section 2518(a) of an interest or any portion of an interest in a joint tenancy or a tenancy by the entirety must be made no later than 9 months after the transfer creating the tenancy. Thus, a surviving joint tenant cannot disclaim any part of the interest, including the survivorship interest, if more than 9 months have passed since the transfer creating the joint tenancy. In addition, a joint tenant cannot make a qualified disclaimer of any portion of the joint interest attributable to consideration furnished by that tenant.[52]

The enacted regulation quoted above did not contain the language of the proposed regulation which required that the entire interest subject to the joint tenancy had to be disclaimed for the disclaimer to qualify.[53] As one authority highlighted, the emphasis, under the premise that joint tenants own the whole and no transfer takes place at death, is arguably consistent with a requirement that a joint tenant must disclaim the whole interest[54] as was required by the proposed regulation.[55] By leaving out this requirement when enacting the proposed regulations, the IRS has begun to shift its premise and recognize that the survivorship interest is a separate interest.[56]

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[51]Prop. Treas. Reg. § 25.2518-2(d)(3), 45 Fed. Reg. 48,922 (1980). *See supra* text accompanying note 42 for language of regulation.

[52]Treas. Reg. § 25.2518-2(c)(4)(i). Subsection (c)(4)(ii) is the special provision for joint tenancy created between spouses between the years of 1976-82 and reads as follows:

> (ii) *Tenancies in real property between spouses created before 1982.* In the case of joint tenancies between spouses or a tenancy by the entirety in real property created after 1976 and before 1982 where no election was made under section 2515, the surviving spouse must make a qualified disclaimer no later than 9 months after the date of death of the first spouse to die. Such a qualified disclaimer will be effective for—
>
> (A) The entire joint interest (except any portion attributable to consideration furnished by the surviving spouse) if the date of death of the deceased spouse is before 1982; or
>
> (B) One-half the value of the joint interest if the date of death of the deceased spouse is after 1981.

[53]*See supra* text accompanying note 42.

[54]Uchtmann, *supra* note 47, at 338.

[55]Prop. Treas. Reg. § 25.2518-2(d)(3), 45 Fed. Reg. 48,926 (1980). *See supra* text accompanying note 42 for language of regulation.

[56]In the Brief for Petitioner at 16-17, Kennedy v. Commissioner, 804 F.2d 1332 (7th

The Service's recognition that separate interests do exist can also be seen in Treasury regulation section 25.2518-2(d)(i). In this regulation, the IRS changed its earlier position that by accepting benefits from any part of the joint tenancy property, a person has accepted benefits from the whole of the jointly owned property.[57] The section reads in part:

> The acceptance of one interest in property will not, by itself, constitute an acceptance of any other separate interests created by the transferor and held by the disclaimant in the same property. In the case of residential property, held in joint tenancy by some or all of the residents, a joint tenant will not be considered to have accepted the joint interest merely because the tenant resided on the property prior to disclaiming his interest in the property.[58]

Although the Service did make minor revisions in the regulations regarding joint property, it retained its earlier position that a qualified disclaimer must be made within nine months of the creation of the tenancy.[59] This position is not consistent with the other changes made in the proposed regulations discussed above which neglected the IRS's recognition of the separateness of the survivorship interest. When enacting the regulations, the IRS noted that some authorities disagreed with its position that a qualified disclaimer must be made within nine months of the creation of the tenancy.[60] The IRS still retained its position, however, because of the holding in the Tax Court Memorandum Opinion of *Kennedy v. Commissioner*,[61] that "each joint tenant receives an interest in the entire property subject to the tenancy, as well as the rights of survivorship, at the time of the transfer creating the joint interest."[62] Three months after the regulations were enacted, the Seventh Circuit, in *Kennedy v. Commissioner*,[63] found the regulation concerning joint tenancy property to be inconsistent with the other regulations under

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Cir. 1986) (No. 33349-83), Petitioner's counsel argued the language in the proposed regulation requiring the entire interest to be disclaimed was inconsistent with § 2518(c)(1) which provided for the disclaimers of undivided interest in property. This argument highlighted one of the reasons why the language was left out of the enacted regulation.

[57]*See supra* notes 49-50 and accompanying text.

[58]Treas. Reg. § 25.2518-2(d)(1) (1986).

[59]*Id.* § 25.2518-2(c)(4)(i). *See supra* text accompanying note 52 for language of regulation.

[60]51 Fed. Reg. 28,365, 28,366 (1986).

[61]Kennedy v. Commissioner, 51 T.C.M. (CCH) 232, *rev'd*, 804 F.2d 1332 (7th Cir. 1986).

[62]51 Fed. Reg. 28,365, 28,366 (1986).

[63]804 F.2d 1332 (7th Cir. 1986).

section 2518 and overruled the *Kennedy* memorandum opinion[64] upon which the Service had relied.[65]

3. Criticism of the Service's Current Position.—The Service's position has been criticized as being fundamentally flawed: "based on shadowy and intricate common law property concepts and ancient fictions that bear little relationship to contemporary property law and reality."[66] It is not too difficult to conceptualize that a surviving joint tenant acquires greater property interest at the death of the other joint tenant.[67] In 1932 the United States Supreme Court recognized this in *Gwinn v. Commissioner*,[68] where it held,

> Although the property here involved was held under a joint tenancy with the right of survivorship created by the . . . transfer, the rights of the possible survivor were not then irrevocably fixed, since under the state laws the joint estate might have been terminated through voluntary conveyance by either party, through proceedings for partition, [or] by an involuntary alienation under an execution . . . . The right to effect these changes in the estate was not terminated until the co-tenant's death . . . . The death became the generating source of definite accessions to the survivor's property rights.[69]

A joint tenant: must account to his co-tenants for any rent and profits exceeding his proportion;[70] can only lease his aliquot portion of

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[64]*Id.* at 1335-36.

[65]51 Fed. Reg. 28,365, 28,366 (1986).

[66]Uchtmann, *supra* note 47, at 339-40.

[67]*Id.* at 340-41.

[68]287 U.S. 224 (1932).

[69]*Id.* at 228-29 (citations omitted). In *Gwinn*, property was acquired as joint tenants in 1915. At that time there were no provisions for federal transfer tax on property passing at death. In 1916 such transfer taxes were enacted and later amended in 1924. One of the co-tenants died in 1924, four months after the enactment of 26 U.S.C. § 1094. The Commissioner of the Internal Revenue interpreted this statute to include the one-half interest the deceased co-tenant passed at her death to the surviving joint tenant in arriving at the value of the estate subject to transfer tax. The petitioner maintained that no interest passed at death, because all interest in the property had passed at creation, which was prior to the enactment of the 1924 or 1916 statutes—thus the statutes should not apply. The court rejected the petitioner's argument, recognizing that an interest did pass at the death of one joint tenant to the surviving joint tenant.

[70]Uchtmann, *supra* note 47, at 340 n.32, reads:

> *See, e.g.*, Graham v. Allen, 11 Ariz. App. 207, 463 P.2d 102 (1970); Swartzbaugh v. Sampson, 11 Cal. App. 2d 451, 54 P.2d 73 (1936); People v. Varel, 351 Ill. 96, 184 N.E. 209 (1932); Pistole v. Lanier, 214 Ky. 290, 283 S.W. 88 (1926); Kahnovsky v. Kahnovsky, 67 R.I. 208, 21 A.2d 569 (1941). *But see* Black v. Black, 91 Cal. App. 2d 328, ____, 204 P.2d 950, 953 (1949) ("[T]here is no

property subject to the rights of co-tenants to enjoy the property;[71] and can technically encumber by mortgage only his proportional interest; and realistically may not be able to find a lender willing to accept such a mortgage.[72] To the extent that the surviving joint tenant's rights are greater as sole owner than as joint tenant, the survivor has acquired something upon the death of the other joint tenant. This reality is inconsistent with the position of the IRS that the joint tenant is seized of the whole at creation and nothing passes at death.[73] As shown by the *Gwinn* decision quoted above,[74] the recognition that there is an interest that passes at death is neither new nor novel. Justice Black also recognized this in the 1939 case of *United States v. Jacobs*[75] where he wrote:

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equity in the claim that the mere fact of being named as joint tenant entitles one to share in the revenues produced on the land as the result of the labor, management and money of him who is in sole possession when the claiming co-tenant has neither demanded possession, contributed to the expense of production nor previously made himself liable for possible losses").

[71]Uchtmann, *supra* note 47, at 341 n.33 reads:

The majority view is that a joint tenant may not bind more than that tenant's aliquot portion of the joint estate: *See, e.g.*, Graham v. Allen, 11 Ariz. App. 207, 209, 463 P.2d 102, 104 (1970); Swartzbaugh v. Sampson, 11 Cal. App. 2d 451, 458, 54 P.2d 73, 77 (1936). In Reiger v. Bruce, 322 Ill. App. 689, 54 N.E.2d 770 (1944), a non-signing joint tenant was allowed to bring an action of forcible entry and detainer to recover the property from the lessee. The lessee does not, however, lose its rights against the signing joint tenant. *See also* National Gas & Co. v. Rizer, 20 Ill. App. 2d 332, 335, 155 N.E.2d 848, 849 (1959).

[72]Uchtmann, *supra* note 47, at 341 n.34 reads:

There is conflicting authority as to whether a creditor's lien or mortgage actually severs a joint tenancy. The matter of severance and thus the outcome upon the death of the debtor-joint tenant depends upon whether the state follows a title, hybrid, or lien theory of mortgages. In a title jurisdiction, conveyance of a mortgage by the joint tenant will sever the tenancy and destroy the right of survivorship. In a lien jurisdiction, there is no severance of the joint interest, and the mortgagee holds only a lien which may "evaporate" if the mortgaging joint tenant is the first to die. Because of the disappearing lien problem in lien jurisdictions, a lender will be less likely to accept a mortgage or other security interest in joint tenancy property, and the ability to use the joint tenancy property as collateral essentially becomes unavailable to a joint tenant who does not desire to sever the joint tenancy and destroy the right of survivorship. For a discussion of creditors' and mortgagees' rights regarding joint tenancy property, *see* Uchtmann & Hartnell, *Qualified Disclaimer of Joint Tenancies: A Policy and Property Law Analysis*, 22 Ariz. L. Rev. 987, 1003-05 (1980) and Mattis, *Severance of Joint Tenancies by Mortgages: A Contextual Approach*, 1977 S. Ill. U.L.J. 27, 45-61.

[73]Uchtmann, *supra* note 47, at 341.

[74]*See supra* note 69 and accompanying text.

[75]306 U.S. 363 (1939).

> Upon the death of her co-tenant [the wife] for the first time became possessed of the sole right to sell the entire property without risk of loss which might have resulted from partition or separate sale of her interest while decedent lived. There was—at his death—a distinct shifting of economic interest, a decided change for the survivor's benefit.[76]

The Service's position does not recognize the reality that the surviving joint tenant receives a substantial economic benefit at the death of the other joint tenant. This position creates several areas of conflict with the Congressional intent behind section 2518.

C. *IRS's Position in Conflict with Congressional Intent Behind § 2518*

There are three areas of conflict that arise between the Service's position and the Congressional intent behind section 2518. The first and most significant conflict is in the definition of what constitutes the transfer which activates the nine-month time limitation in the statute.[77] The second conflict exists between the Congressional intent behind the enactment of section 2518, to provide a more uniform federal disclaimer law by alleviating reliance on state disclaimer laws, and the Service's interpretation of section 2518, which results in reliance on state law.[78] The third conflict arises between the Service's position, which discriminates against owners of joint tenancy property, and the broader goals of the tax law to treat taxpayers fairly.[79]

1. Definition of Transfer.—When commenting on the statutory requirement that "the written refusal must be received by the transferor of the interest . . . not later than nine months after the day on which the transfer creating the interest is made,"[80] the House Ways and Means Committee stated: "For purposes of this requirement, a transfer is considered to be made when it is treated as a *completed transfer for gift tax purposes* with respect to inter vivos transfers or *upon the date of the decedent's death* with respect to testamentary transfers."[81] The Conference Committee report reflected the same intent by stating: "The Conferees intend to make it clear that the 9-month period for making

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[76] *Id.* at 371.

[77] I.R.C. § 2518(b)(2) (1987). The exact language is reproduced in note 31 *supra*. *See infra* text accompanying notes 80-93 for further discussion.

[78] *See* H.R. Rep. No. 1380, *supra* note 32, at 66-67. *See infra* text accompanying notes 94-107 for further discussion.

[79] *See infra* text accompanying notes 108-16 for further discussion.

[80] *See* H.R. Rep. No. 1380, *supra* note 32, at 67 (emphasis added).

[81] *Id.*

a disclaimer is to be determined in reference to each *taxable transfer*."[82]

At the time of creation of a joint tenancy by a donor of property, the only tax that may occur is a gift tax on the value of the one-half interest conveyed to the donee to the extent the value of the one-half interest exceeds the donee's contribution.[83] The portion retained by the donor which would pass at his death to the donee, if the donee survives him, is never taxed at creation and only becomes a "taxable transfer" at the death of the donor.[84] If both parties contributed equally to the purchase of the joint tenancy property, there is no gift tax at creation. Also, in this case the only "taxable transfer" occurs at the death of one of the tenants when the surviving tenant receives the decedent's one-half interest.[85]

If the intent of Congress is that the transfer creating the interest means a *taxable transfer*, then the donee above would have nine months from creation of the tenancy to disclaim his one-half proportional interest in the property. But with respect to the accretive interest,[86] which would only pass at the death of the donor, he would have nine months from the donor's death to disclaim. Similarly in the case of equal contributions, the survivor would have nine months from the decedent's death to disclaim the accretive interest which would pass to him at the decedent's death.

This application of Congressional intent to joint tenancy disclaimer is supported by the fact that House Report 1380 defining "transfer"

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[82]*Joint Explanatory Statement of the Committee of Conference*, S. Rep. No. 1236, 94th Cong., 2d Sess. 607,623.24, *reprinted in* 1976 U.S. Code Cong. & Admin. News 4262, 4266 (emphasis added).

[83]I.R.C. §§ 2511, 2512 (1987).

[84]The value of the donor's interest in the joint tenancy property is included in the donor's estate at his death. I.R.C. § 2040 (1987). The transfer of the estate, which is defined to include the donor's interest in the joint property, occurs upon the donor's death and is a taxable transfer. I.R.C. at § 2001(a). Thus, the donee should have nine months from the time of this taxable transfer to disclaim the accretive portion (the donor's interest), which is nine months from the date of the donor's death.

I.R.C. § 2040(b)(1) (1987) provides in the case of a "qualified joint interest," only one-half of the value of the joint tenancy property is includible in the gross estate of the deceased joint tenant, without regard to which joint tenant paid for the property. In order to be a "qualified joint interest," the property must be held in joint tenancy by the decedent and his or her spouse at the time of the decedent's death; no other person may have an interest in the property. Further, the joint tenancy must have been created by the decedent, by the decedent's spouse, or by both. I.R.C. § 2040(b)(2) (1987).

[85]*See supra* note 80 and accompanying text.

[86]Uchtmann defined the proportional interest as that one-half interest which passes at the creation of the joint tenancy and the accretive interest as that interest which contains the survivorship one-half interest and passes at the death of the first tenant to die. Uchtmann, *supra* note 47, at 343.

also noted that "many professional study groups had recommended that definite rules be provided with respect to the treatment of disclaimers for estate and gift tax purposes."[87] It cited the American Bar Association Recommendation Number 1974-2, which states:

> Joint interests vesting as a result of survivorship may be disclaimed within nine months after the death of the deceased joint tenant to the extent that the interest is includible in the estate of the deceased joint tenant. To the extent that the property is not includible in the estate of the deceased joint tenant, the disclaimer must be made no later than nine months after creation of the joint tenancy.[88]

One of the Treasury Regulations enacted in 1986 is in line with Congressional intent on this issue and states, "[t]he rules described in §§ 25.2518-1 through 25.2518-3 apply to the qualified disclaimer of an interest in property which is created in the person disclaiming by a *taxable transfer* made after December 31, 1976."[89] The enacted regulations also have a specific section on "transfers" which includes almost verbatim the language of the House Ways and Means Committee concerning taxable transfers.[90] However, the regulation concerning jointly held property, which states that the time period begins to run at the creation of the tenancy,[91] ignores the taxable transfer as being the time at which the nine-month limitation begins to run. Therefore, it is inconsistent with the transfer section of the regulations[92] and Congressional intent.

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[87]*See* H.R. Rep. No. 1380, *supra* note 32, at 66 n.5.

[88]*American Bar Association Tax Section Recommendation No. 1974-2*, 27 Tax Law. 818, 820 (1973).

[89]Treas. Reg. § 25.2518-1(a)(1) (1986) (emphasis added). The Service's original position was contrary to this. It recognized this Congressional intent as to transfer in a private letter ruling, Priv. Ltr. Rul. 81-400-11 (June 29, 1981), but stated, "[w]hile this language is useful in determining Congressional intent as to when the 9-month period begins to toll under section 2518, it is not relevant for purposes of the effective date provisions." *Id.* The IRS determined that the transfer creating the decedent's interest was the creation of the tenancy in 1963 and held section 2511, rather than section 2518, governed the validity of the decedent's disclaimer. *Id.*

The House Ways and Means Committee defined the "transfer that created the interest" as being the taxable transfer at one point in their report. *See* H.R. Rep. No. 1380, *supra* note 32, at 67. Later in the same report, the Committee used the previously defined language in stating "[t]he amendments apply with respect to 'transfers creating an interest' in the person disclaiming made after December 31, 1976." *Id.* It appears odd that the Committee would have in mind a definition other than that of the taxable transfer.

[90]Treas. Reg. § 25.2518-2(c)(3) (1986). *See infra* note 166 for language of regulation.

[91]Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See infra* text accompanying note 52 for language of regulation.

[92]Treas. Reg. § 25.2518-2(c)(3) (1986). *See infra* note 166 for language of regulation.

The Seventh Circuit highlighted this discrepancy when it reversed the Tax Court in *Kennedy*.[93]

2. Uniform Federal Disclaimer Law That Was Not Dependent on Local Law.—Prior to the enactment of section 2518, a disclaimer had to be valid under local law to be effective for purposes of the federal estate and gift tax.[94] The legislative history behind the enactment of section 2518 states that "[w]hen Congress enacted section 2518, it intended to create a uniform Federal standard so that a disclaimer would be effective for Federal estate and gift tax purposes whether or not valid under local law."[95] In spite of this Congressional intent, the proposed regulation section 25.2518-1(c)(1) required that the disclaimer be effective under local law.[96] The proposed regulation reflected the fact that, by stating in section 2518(b)(4) that the interest must pass "without any direction"[97] on the part of the disclaimant, and by not providing a way to complete the transfer, Congress had made section 2518 dependent upon local law.[98] In the ERTA of 1981, in an effort to alleviate this dependency on local law, Congress amended section 2518 by adding subsection (c)(3).[99] The amendment permitted a direct transfer to qualify as a disclaimer for federal tax purposes if the grantee is the person who would have received the property had the grantor simply disclaimed the interest. The transfer must also meet the other requirements set down in section 2518(b).[100]

The conflicting proposed regulation was revised before being enacted in 1986 to reflect the Congressional intent stated above.[101] For transfers prior to 1982, the enacted form provided that one could make a qualified

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[93]Kennedy v. Commissioner, 804 F.2d 1332, 1335 (7th Cir. 1986).

[94]Treas. Reg. § 25.2511-1(c) (as amended in 1986). *See supra* note 26 for text of regulation.

[95]S. Rep. No. 144, *supra* note 40, at 142; H.R. Rep. No. 201, 97th Cong., 1st Sess. 190 (1981).

[96]Prop. Treas. Reg. § 25.2518-1(c)(1), 45 Fed. Reg. 48,922 (1980).

[97]I.R.C. § 2518(b)(4) (1987). *See supra* note 31 for text of statute.

[98]*See* Martin, *Perspectives on Federal Disclaimer Legislation*, 46 U. Chi. L. Rev. 316, 323-35 (1979).

[99]I.R.C. § 2518(c)(3) (1987), *added by* ERTA § 426(a). *See supra* note 31 for text of statute.

[100]I.R.C. § 2518(c)(3) (1987). *See supra* note 31 for text of statute. According to one authority the wording of § 2518(c)(3) seemingly limits its application to transfers for the transferor's "entire interest in the property." Curiously, however, § 2518(c)(1) creates an apparent discrepancy by making the qualification rules of subsection (b) applicable to an undivided portion of the interest, as well as to an entire interest. Irrespective of any minor ambiguities, one thing seems clear: Congress intended to create uniform tax treatment of disclaimer, and it is willing to take the necessary steps to achieve that goal. Morris, *supra* note 26, at 62 n.117.

[101]Treas. Reg. § 25.2518-1(c)(1)(i) (1986). *See also* 51 Fed. Reg. 28,366 (1986).

disclaimer under section 2518, regardless of whether the requirements of local law were met, "if, under local law, the disclaimed interest in property is transferred, as a result of attempting the disclaimer, to another person without any direction on the part of the disclaimant."[102] No regulation has yet been promulgated for an interest created after 1981, which would apply to the 1981 amendment by the addition of section 2518(c)(3).[103]

The efforts to make federal disclaimer law more uniform and less dependent on state and local law have not been successful.[104] One area in particular is the application of federal disclaimer laws to joint tenancy property. The majority of states now have disclaimer laws allowing the disclaimer of the accretive interest in joint tenancy property.[105] Where state law allows the disclaimer of the accretive interest in joint tenancy property, some courts have taken the view that the state disclaimer law changes the nature of the property ownership at death to that of tenants in common and, therefore, have allowed the disclaimer of the accretive interest as a qualified federal disclaimer.[106] Because courts may interpret differently the way state disclaimer laws affect property interest and the application of section 2518, the Treasury regulations for section 2518 have not provided for uniform treatment of federal disclaimers of joint tenancy property. In addition, some states do not have disclaimer laws for joint tenancy property.[107] Taxpayers in these states will not have the

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[102]Treas. Reg. § 25.2518-1(c)(1)(i) (1986).

[103]Treas. Reg. § 25.2518-1(c)(1)(ii) (1986).

[104]*See generally* Schain, *supra* note 26.

[105]Uchtmann, *supra* note 47, at 342, n.37, provides:

> *E.g.*, Ark. Stat. Ann. § 62-3202(d) (Supp. 1983); Conn. Gen. Stat. Ann. § 45-300 (West Supp. 1984); Hawaii Rev. Stat. § 560:2-801 (1976 & Supp. 1983); Idaho Code § 15-2-801(a) (1979); Me. Rev. Stat. Ann. tit. 18A, § 2-801(c) (1981); Mass. Gen. Laws Ann. ch. 191A, § 2 (West 1981); Neb. Rev. Stat. § 30-2352(a) (1979); S.D. Codified Laws Ann. § 43-4-30.1 (1983); Utah Code Ann. § 75-2-802(1)(a) (1978); Wash. Rev. Code § 11.86.020 (1984). Generally, all states have statutes allowing the disclaimer of property that would pass to the disclaimant by virtue of the state's statute of descent and distribution. For a detailed listing of these statutes, *see* Frimmer, *Disclaimers After the Tax Reform Act of 1976: Chaos Out of Disorder*, 31 U.S.C. Tax Inst. 811, 822 n.41 (1979). *But see* Comment, *Federal Taxation: Section 2518 Disclaimers-Anything But Uniform*, 31 U. Fla. L. Rev. 188, app. D, at 209-10 (1978).

[106]Hoffman v. United States, 85-2 U.S. Tax Cas. 90430 (CCH) (D. Neb. 1985); Ferguson v. United States, 48 A.F.T.R.2d (P-H) ¶ 148,472 (D. Ariz. 1981). These cases will be discussed further at text accompanying *infra* notes 117-32.

[107]As of 1984, Mississippi, New Hampshire and Vermont had no disclaimer statutes applicable to intestate interests. Uchtmann, *supra* note 47, at 342, n.37. North Carolina has no disclaimer statute applicable to joint tenancy interest. Estate of Dancy v. Commissioner, 89 T.C. 550 (1987). *See infra* note 199 for a discussion of *Estate of Dancy* which deals with the disclaimer of joint tenancy property.

option of using state disclaimer laws to change their joint property interest so that federal disclaimer law will apply, again creating more disparity in the application of federal disclaimer law.

3. The Service's Position Conflicts With Broader Goals of Tax Law.—The Service's position is also in conflict with several broader goals underlying the tax laws.[108] By its inconsistent position on disclaimers, the IRS treats similarly situated taxpayers differently.[109] It also makes the form of the transaction, rather than its substance, control the tax consequences.[110] The result is a tax structure that taxpayers will regard as unfair.[111] This is demonstrated by the Service's disparate treatment of joint tenants and tenants in common. If a couple owned a farm worth $1,200,000 as tenants in common, zero tax would accrue in passing the farm on to the next generation. This is assuming that the decedent left his one-half undivided interest in the tenancy in common property to the surviving spouse in his will, and that she disclaimed it under section 2518 within nine months of decedent's death.[112] The same farm owned as joint tenants, under the Service's position regarding joint tenancy property, would, in passing it to the next generation, result in a $235,000 estate tax (as shown by example earlier).[113] One authority questions the extent to which early common law distinctions between

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[108]*Federal Estate and Gift Taxation: Recommendations of the American Law Institute and Reporters' Studies* 78 (1969). They articulated seven goals in formulating recommendations for reform of the federal estate and gift tax system:

> In relation to any proposals in the gift and estate tax area, a decision must be made on the goals which tax legislation in this field is designed to accomplish. The goals which have guided this Study are as follows (not necessarily listed in the order of their importance):
>
> (1) to produce revenue;
>
> (2) to impose reasonable restrictions on the inheritance of wealth;
>
> (3) to guard against the destruction of incentives to accumulate wealth;
>
> (4) to reduce, if not eliminate, the circumstances under which the form of a transfer will affect the tax result;
>
> (5) to have a tax system that is readily understandable in the normal and routine transfer situations;
>
> (6) to treat taxpayers similarly situated in the same manner; and
>
> (7) to produce a tax structure that will be regarded as fair.

It is obvious that in some instances the achievement of some of these goals will call for solutions directly opposite to the achievement of other goals. In such instances, a decision has to be made as to which goals should predominate.

[109]*See supra* note 108 goal 6.

[110]*See supra* note 108 goal 4.

[111]*See supra* note 108 goal 7. For a discussion of these goals, see Uchtmann & Hartnell, *supra* note 72, at 989-92.

[112]The tax computations for such an estate would be the same as in example 2 given earlier in the text. *See supra* notes 21-22 for computations.

[113]*See supra* notes 19-20 for computations.

tenants in common and joint tenants have disappeared over time, and in light of this, whether a policy which discriminates between a tenant in common and a joint tenant regarding the right to disclaim an accretive undivided interest in property can be justified.[114]

The special use valuation section 2032A,[115] provides that, for tax purposes, qualifying farmland transferred in a decedent's estate can be transferred at its income-generating value rather than its market value. Congress has thus recognized the large estate tax burden faced by farmers when passing their family farms and businesses to the next generation. However, the significant tax saving under this section is not available for inter vivos transfers[116] and thus provides a strong incentive to hold on to farmland until death. The Service's position increasing the estate tax burden on farm couples who own their land as joint tenants is not in line with Congress' actions to help decrease the estate tax burden for farm couples. Because the special use valuation benefits for agricultural property of section 2032A are only available for transfers at death, the Service's position also would not allow farm couples to pass title to farmland to their children who may have joined the family business at the death of the first parent, but would force them to wait until the death of the second.

D. The Courts' Treatment of Disclaimers of Joint Tenancy Prior to Kennedy

The Service's position that the nine-month time period for disclaiming joint tenancy property begins to run at the creation of the tenancy and not at the death of one of the joint tenants, is based on a series of private letter rulings discussed earlier.[117] These letter rulings cannot be cited as precedent and are merely opinions of the IRS on specific issues raised by inquiring taxpayers.[118] Prior to *Kennedy* only two courts addressed the issue of disclaiming joint tenancy property interest. The first was the Federal District Court for the District of Arizona in *Ferguson v. United States.*[119] Because the creation of the joint interest, the death of one of the joint owners, and the attempted disclaimer by the surviving joint owner all occurred prior to 1977, the court applied pre-section 2518 law (section 2511). The court concluded that in light of the existing Arizona disclaimer statutes a new statutory basis for the existence of

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[114]Uchtmann, *supra* note 47, at 350. For examples of disparate tax treatment, see *id.* at 347-50.

[115]I.R.C. § 2032A (1987).

[116]*Id.*

[117]*See supra* notes 43-50 and accompanying text.

[118]I.R.C. § 6110(j)(3) (1987).

[119]48 A.F.T.R.2d (P-H) ¶ 148,472 (D. Ariz. 1981).

joint estates had replaced the common law, and that a joint tenant could make an effective disclaimer even though the renunciation came long after the creation of the joint estate.[120]

The court reasoned that the right of survivorship interest, not the joint interest itself, was the interest being disclaimed. It interpreted the state statute to mean that upon renunciation of a joint interest at the death of one co-tenant, the joint estate is destroyed and is replaced by a tenancy in common which arises at the time of the renunciation. The surviving tenant could then disclaim ownership in the deceased tenant's share, provided the survivor had not accepted any benefits of that interest he could not have accepted as a tenant in common.[121] The court's result implies that the statute has altered the common law of joint tenancy. If other statutory requirements were met, the court saw no difficulty in recognizing practical realities and permitting the disclaimer.[122]

Although in *Ferguson* section 2511 controlled because the transfer was prior to 1977, the same rationale as to the effect of state disclaimer law on the nature of joint tenancy property could easily be applied to post 1977 transfers under section 2518. In fact, prior to *Kennedy*, the only other case that addressed the issue of disclaiming joint interest, *Hoffman v. United States*,[123] applied section 2518 and used a very similar approach in allowing the disclaimer of the survivorship interest in joint tenancy property. In *Hoffman*, a husband and wife bought a quarter section of land in 1943, each making equal contributions and taking title as joint tenants with right of survivorship.[124] The husband died in 1979 and the wife made a written disclaimer of an undivided one-half interest in the jointly held property within seven months of his death. The *Hoffman* court decided that Treasury Regulation Section 25.2511-1(c) did not apply because the creation of the tenancy in 1943 was not the result of a transfer and the regulation applied only to "property transferred from a decedent (whether the transfer is effected by the decedent's will or by the law of descent and distribution of intestate property)."[125]

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[120] *Id.*

[121] *Id.*

[122] *Id. See also* Morris, *supra* note 26, at 64. In his article, Morris proposes a new form of property ownership, "statutory tenancy," similar but yet distinct from joint tenancy. For a further discussion of this form of ownership as compared to joint tenancy and the property interest in *Ferguson* after applying state disclaimer law, see Morris, *supra* note 26, at 65-78.

[123] 85-2 U.S. Tax Cas. (CCH) ¶ 90,430 (D. Neb. 1985).

[124] These facts differ slightly from those in *Kennedy* and *Ferguson* where only one spouse bought the property and then titled it as joint tenants with rights of survivorship, making a gift of the one-half undivided interest at the time. *Id.*

[125] *Id.*; *see also* Treas. Reg. § 25.2511-1(c) (as amended in 1986). *See supra* note 26 for text of regulation.

The question then became whether the change in title effected by the death of a joint tenant in Nebraska is included in the meaning of the language in section 2518, "transfer creating an interest," which was considerably broader than the previous regulation language, because it was not restricted to transfers from a decedent.[126] In examining Nebraska law on disclaimer of joint tenancy interest, the court found that the husband's death brought about a transfer that created an interest in the surviving spouse that she did not possess prior to his death; an interest which she could disclaim if done within nine months.[127] Under Nebraska law

> [T]he disclaimer, which relates back to the time of death, has the effect of severing the joint tenancy by destroying the right of survivorship and converting the estate into a tenancy in common between the survivor and the successor of the renounced interest; then, as a tenant in common, the survivor still has the right to possession of the entire property, subject to the same right of the other tenant.[128]

The disclaimer raised no questions concerning the acceptance of prior benefits. "The only benefits that could be accepted from the decedent's interest before it is renounced that are not merely benefits inherent in the survivor's own interest by means of the unity of possession common to both estates are those that could be obtained by assignment, conveyance, encumbrance, pledge or transfer of the property,"[129] none of which the surviving spouse had done.

In addition to using the *Ferguson* court's rationale as to the effect of state disclaimer law, the *Hoffman* court went on to make a comparison between disclaiming inheritance by intestate succession and disclaiming the survivorship right of joint tenancy property.[130] From this comparison the court made a very convincing argument that the two should be treated the same. The court reasoned that an heir after disclaiming her inheritance is left in the same position as before the intestate's death, except that now she no longer has an expectancy of inheritance. The court continued by pointing out that in either case (that of a joint tenancy or intestate succession) the prior interest holder could have done an inter vivos act "by making a will, in the case of inheritance, or by severing the joint tenancy unilaterally . . .—to defeat the heir's or co-

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[126]*Hoffman*, 85-2 U.S. Tax Cas. at 90,434.
[127]*Id.*
[128]*Id.*
[129]*Id.*
[130]*Id.* at 90,435.

owner's expectancy. And in each case the value of the decedent's interest is included in the gross estate for death tax purposes."[131]

In both *Ferguson* and *Hoffman* the outcome was very dependent on state law. Such dependency is in direct conflict with one of Congress' main goals in passing section 2518—to make a uniform federal disclaimer law that was not dependent on state or local law.[132] Neither case addressed the issue of whether the transfer from which the time limit ran had to be taxable under section 2518, which was also an intent of Congress when it enacted the section. Both courts, however, did show a willingness to circumvent the Service's position that an effective disclaimer of a joint tenancy interest must be done within nine months of the creation of the tenancy.

IV. The Kennedy Case

A. The Facts

In 1953, Frank Kennedy acquired 160 acres of Illinois farmland. Frank then created a joint tenancy with the right of survivorship with his wife, Pearl Kennedy, by transferring a one-half undivided interest in the farmland to her.[133] Frank died in 1978 and within nine months of his death Pearl disclaimed the interest she had acquired in the farm by surviving Frank. Under the law of Illinois, this former interest of Frank's passed to the Kennedy's daughter, Marsha. The IRS believed that the disclaimer was ineffective under federal law resulting in the property vesting in Pearl and that by attempting to now disclaim the property under state law, Pearl was transferring her property to her daughter which resulted in a taxable gift.[134] Relying on the 1982 Supreme Court case of *Jewett v. Commissioner*,[135] the Tax Court agreed, holding that Pearl's time to make a "qualified" disclaimer (one that avoids the

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[131] *Id.* (citing I.R.C. § 2040(a); Treas. Reg. § 20.2040-1(a), -1(b)).

[132] *See supra* text accompanying notes 94-107.

[133] Kennedy v. Commissioner, 804 F.2d 1332, 1333 (7th Cir. 1986). Frank furnished all the consideration for the land. Therefore, under current law at that time, although no taxable gift was reported, one took place for the undivided one-half interest transferred to Pearl. The Internal Revenue Code was amended effective 1954 to create a special treatment of marital joint tenancies. *See* I.R.C. § 2515 (repealed effective 1982). It now allows a deduction equal to the value of gifts to a spouse. *See* I.R.C. § 2523(a) and (d) (1987). However, neither of these changes affect the principal case because the joint tenancy was created in 1953, prior to these changes.

[134] *Kennedy*, 804 F.2d at 1333.

[135] 455 U.S. 305 (1982).

imposition of tax) had been running since 1953 and therefore had expired long before Frank died.[136]

The case was appealed and the Seventh Circuit became the first court of appeals to consider the appropriate treatment of disclaimed interests in real estate held through joint tenancies.[137] The Seventh Circuit disagreed with the lower tax court holding and its application of the *Jewett* case. Because Illinois state law allowed either joint tenant to partition the property at will, the Seventh Circuit held that Pearl Kennedy had acquired the family farm in two steps.[138] The first step was at the creation of the tenancy in 1953 when she acquired an undivided one-half interest in the property. The second step was the transfer of the survivorship interest which occurred at the death of her husband. "The time within which Pearl could disclaim the half of the property she received because of Frank's death started to run in 1978 and is therefore governed by the 1976 statute."[139] Having decided the timing issue and which statute applied, the court remanded the case for further proceedings by the Tax Court to determine whether Pearl had accepted any interest or benefits as the terms are used in section 2518 and the implementing regulations.[140] On March 9, 1987, the Commissioner filed a Memorandum on Remand stating that he "will not pursue the argument that the petitioner accepted any interest in, or benefit from, the property."[141]

B. *Analysis of the Court's Decision*

In reaching its holding the Seventh Circuit first distinguished *Jewett.* It agreed with the Supreme Court's holding in *Jewett* as it applied to contingent remainders, but disagreed with the tax court's application of the *Jewett* holding to survivorship interest in jointly held property.[142] Second, the Seventh Circuit compared the survivorship interest in states where joint tenants have a right to partition to a general power of appointment. From this the court found an inconsistency in the federal regulations' treatment of disclaimers of general power in appointments and disclaimers of joint tenancy interests, and reasoned that the provision for general power of appointments was the one most applicable.[143]

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[136]Kennedy v. Commissioner, 51 T.C.M. (CCH) 232, *rev'd*, 804 F.2d 1332 (7th Cir. 1986).

[137]*Kennedy*, 804 F.2d at 1336.

[138]*Id.*

[139]*Id.*

[140]*Id.*

[141]Memorandum of Commissioner on Remand (March 9, 1987), Kennedy v. Commissioner, 804 F.2d 1322 (7th Cir. 1986).

[142]*Kennedy*, 804 F.2d at 1334.

[143]*Id.* at 1335-36.

1. The Jewett Decision.—Because the *Jewett* case involved a trust and four generations of the Jewett family, its facts are rather complex. The court in *Kennedy* used Roman numerals to designate the different generations and described the trust as follows:

> Margaret Weyerhauser Jewett (Jewett I) died [in 1939], creating a trust in which her spouse and children (Jewett II) had a life estate. On the death of the last life tenant, the corpus of the trust would go to surviving members of generation III. If the last life tenant survived any particular member of generation III, then that member's share of the corpus would go to generation IV, the children of the deceased member of generation III—if necessary, to the descendants of generation IV per stirpes.[144]

In 1972, while one member of generation II was still alive, George Jewett, a member of generation III, disclaimed any interest in the corpus of the trust. His interest under state law then passed as if he had deceased, making his children (Jewett IV) the direct beneficiaries of his share, worth over $4 million.[145] The IRS proposed to levy a gift tax on the actuarial value of George's interest in the corpus of the trust. George argued that because it was not possible to know who would receive the corpus until the last life tenant died, he should not be charged with making a gift of such an uncertain amount to his children.[146] The Supreme Court held to the contrary. It held that George's interest in the corpus was created in 1939 when Jewett I died. Because he had not disclaimed within a "reasonable" time from that date, his interest in the corpus would be considered received by him and given to his children and therefore subject to a gift tax.[147]

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[144] *Id.* at 1333.

[145] *Id.* at 1334.

[146] *Id.*

[147] *Jewett*, 455 U.S. at 319-20. Prior to the Supreme Court decision in *Jewett*, the Eighth Circuit decision in *Keinath v. Commissioner*, 480 F.2d 57 (8th Cir. 1973), was the prevailing view on disclaimers of contingent remainder interest. The court's holding was that an unequivocable disclaimer of a vested remainder subject to divestiture, filed within six months of the death of the life tenant, was made within a "reasonable time." The court said that remainder interests which are not subject to divestiture should be disclaimed within a reasonable time after the testator's death. Where a remainder interest is subject to divestiture, however, the reasonable time is measured from the death of the life tenant. *Id.* at 64. This position was generally approved by the Eighth Circuit in 1980 by *Cottrell v. Commissioner*, 628 F.2d 1127 (8th Cir. 1980).

In 1980 the Ninth Circuit held in *Jewett v. Commissioner*, 638 F.2d 93 (9th Cir. 1980), *aff'g* 70 T.C. 430 (1978), that the "reasonable time" tolls at the creation of the interest, not after the interest indefeasibly vests. *Id.* at 95-96. This decision created a conflict between the circuits, and the Supreme Court granted certiorari in *Jewett* on June 1, 1981. 452 U.S. 904 (1981).

The Seventh Circuit in *Kennedy* agreed that *Jewett* "shows that a belated disclaimer may be a taxable gift even though the person disclaiming has no current access to the money and may never receive it."[148] However, the Seventh Circuit disagreed with the IRS's conclusion that *Jewett* should apply to Pearl Kennedy's disclaimer. In *Jewett* the interests of the different generations of the Jewett family were fixed in 1939. The future interest of each generation had a present value which could have been calculated from the actuarial tables in 1939 or in 1972 to determine what the value of each person's share of the trust corpus was at that time.[149] This was not the case with Frank Kennedy's gift to his wife in 1953 with respect to the survivorship interest. The undivided one-half interest that Frank retained had no value to Pearl that could be ascertained in 1953 because Frank retained the right to partition the property.[150] He retained this right up until his death; therefore, it was not until his death in 1978 that the survivorship interest value could be ascertained.[151] If the survivorship component of a joint tenancy was treated as a valuable gift in 1953, then that would imply that Frank's retained interest was worth less than half of the total value of the farm because Frank's and Pearl's shares, when added together, could not be more than 100 per cent. However, Frank also had a right of survivorship, plus the half share that he could retain with certainty by partition.[152] The court found that the IRS's treatment of the transfer in 1953 implied both Frank and Pearl's interest was worth more than one-half and this suggested something was seriously wrong with the IRS's position.[153]

The petitioner in *Kennedy* argued in her brief that the issue in *Jewett* revolved around the Supreme Court's interpretation of "transfer."[154] She argued that the *Jewett* court's interpretation was that in order to trigger the time period the transfer had to be a taxable transfer. In *Jewett*, when Jewett I died in 1939, there was a taxable transfer at that time of a future interest to George Jewett (Jewett III); therefore, the reasonable time period under section 2511 began to run.[155] When Frank titled the property jointly with Pearl in 1953 he made a taxable gift of the undivided one-half interest she acquired at that time. However, the survivorship

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[148]*Kennedy v. Commissioner,* 804 F.2d 1332, 1334 (7th Cir. 1986).

[149]*Id.*

[150]*Id.* at 1335.

[151]*See* Estate of Lidbury v. Commissioner, 800 F.2d 649, 653-54 (7th Cir. 1986). A contract to make a gift is not a taxable gift when the value of the interest to be transferred is subject to diminution at the donor's pleasure.

[152]*Kennedy*, 804 F.2d at 1335.

[153]*Id.*

[154]Brief for Petitioner at 24, Kennedy v. Commissioner, 804 F.2d 1332 (7th Cir. 1986) (No. 33349-83).

[155]*Id.*

interest she acquired at that time in the one-half undivided interest he retained was not taxable under the gift tax laws until Frank died in 1978.[156] Therefore, because it was this latter interest Pearl was disclaiming, she argued that, according to *Jewett*, it was the taxable event of Frank's death in 1978 that triggered the nine-month time period and section 2518 should apply.[157]

The Congressional intent behind section 2518 supports the interpretation that it is the taxable transfer that triggers the time limit and determines whether section 2511 for transfers prior to December 1976, or section 2518 for those after December 1976 will apply.[158] The IRS has also enacted Treasury Regulations for section 2518 that reiterate that it is the taxable transfer that triggers the nine-month time limitation under section 2518.[159] The *Kennedy* court's holding is in line with both Congressional intent behind section 2518 and the Treasury Regulation's definition of what constitutes a transfer for purposes of section 2518.[160] Although the court's holding comports with both of these, it is in direct conflict with Treasury Regulation Section 25.2518-2(c)(4), which states that a disclaimer of a joint tenancy interest must be made within nine months of the creation of the tenancy.[161] Because the resolution of this conflict may affect a significant number of taxpayers, it is necessary to analyze the conflict and determine which approach should prevail.

2. Kennedy Court Finds the Treasury Regulations Inconsistent.— The court equated Frank's power of partition to a general power of appointment over Pearl's survivorship interest, "because by partitioning the property Frank could direct his half to his creditors and legatees of his choice rather than Pearl."[162] The court also found similarities in that current tax law pulls the value of the jointly held property into the estate of a contributing deceased joint tenant,[163] just as a general power of appointment pulls the value of a trust into the estate of the person who dies while holding the power.[164] With a general power of appointment the effective transfer occurs when the holder of the general power exercises it or allows it to lapse, and the time to disclaim then

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[156]*Kennedy*, 804 F.2d at 1335. *See* Gift Tax Regulations 108, §§ 86.2, 86.19(h) (1943); for treatment under current law, see *supra* note 84 and accompanying text.

[157]Brief for Petitioner at 24, Kennedy v. Commissioner, 804 F.2d 1332 (7th Cir. 1986) (No. 33349-83).

[158]*See supra* notes 80-81 and accompanying text.

[159]*See supra* notes 89-90 and accompanying text.

[160]*See infra* note 166 for language of regulation.

[161]For the complete language of Treas. Reg. § 25.2518-2(c)(4)(i), *see supra* text accompanying note 52.

[162]*Kennedy v. Commissioner*, 804 F.2d 1332, 1335 (7th Cir. 1986).

[163]I.R.C. § 2040(a) (1987).

[164]I.R.C. § 2041(a)(2) (1987).

begins.[165] The regulations under section 2518 support this treatment of the situation: "A person to whom any interest in property passes by reason of the exercise or lapse of a general power may disclaim such interest within a 9-month period after the exercise or lapse."[166] The court reasoned that Frank's right to partition, which was similar to a general power of appointment, lapsed at his death and, therefore, Pearl had nine months from that time to disclaim the survivorship interest in the farm.[167]

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[165]*Kennedy*, 804 F.2d at 1335.

[166]Treas. Reg. § 25.2518-2(c)(3). The full text reads as follows:

Transfer. For purposes of the time limitation described in paragraph (c)(1)(i) of this section, the 9-month period for making a disclaimer generally is to be determined with reference to the taxable transfer creating the interest in the disclaimant. With respect to inter vivos transfers, a taxable transfer occurs when there is a completed gift for Federal gift tax purposes regardless of whether a gift tax is imposed on the completed gift. Thus, gifts qualifying for the gift tax annual exclusion under section 2503(b) are regarded as taxable transfers for this purpose. With respect to transfers made by a decedent at death or transfers which become irrevocable at death a taxable transfer occurs upon the date of the decedent's death. However, where there is a taxable transfer of an interest for Federal gift tax purposes and such interest is later included in the transferor's gross estate for Federal estate tax purposes, the 9-month period for making a qualified disclaimer is determined with reference to the earlier taxable transfer. In the case of a general power of appointment, the holder of the power has a 9-month period after the creation of the power in which to disclaim. A person to whom any interest in property passes by reason of the exercise or lapse of a general power may disclaim such interest within a 9-month period after the exercise or lapse. In the case of a nongeneral power of appointment, the holder of the power, permissible appointees, or takers in default of appointment must disclaim within a 9-month period after the original taxable transfer that created or authorized the creation of the power. If the transfer is for the life of an income beneficiary with succeeding interests to other persons, both the life tenant and the other remaindermen, whether their interests are vested or contingent, must disclaim no later than 9 months after the original taxable transfer. In the case of a remainder interest in property which an executor elects to treat as qualified terminable interest property under section 2056(b)(7), the remainderman must disclaim within 9 months of the transfer creating the interest, rather than 9 months of the date such interest is subject to tax under section 2044 or 2519. A person who receives an interest in property as the result of a qualified disclaimer of the interest must disclaim the previously disclaimed interest no later than 9 months after the date of the taxable transfer creating the interest in the preceding disclaimant. Thus, if A were to make a qualified disclaimer of a specific bequest and as a result of the qualified disclaimer the property passed as a part of the residue, the beneficiary of the residue could make a qualified disclaimer no later than 9 months after the date of the testator's death. See paragraph (d)(3) of this section for the time limitation rule with reference to recipients who are under 21 years of age.

[167]*Kennedy v. Commissioner*, 804 F.2d 1332, 1336 (7th Cir. 1986).

The *Kennedy* court noted that the regulations treated other interests, such as joint bank accounts, similarly.[168] The Commissioner treats a joint account between A and B, where A has provided all the funds, as a transfer to B only when it becomes irrevocable. The transfer becomes irrevocable when B withdraws the money or A dies. If B does not withdraw the funds during A's life, B has nine months after A's death to disclaim any interest in the account.[169]

The court also noted that the new regulation treated a survivorship interest in land as a completed, irrevocable gift on the date the tenancy itself was created.[170] The court found this "inconsistent with the Commissioner's treatment of general powers of appointment and joint bank accounts when, as is true in Illinois, either spouse may terminate the right of survivorship by partitioning the property."[171] Because of the prospect of partition, only the one-half undivided interest had been transferred irrevocably. The survivorship interest could have been withdrawn at will, just as funds in a joint account could have been. The court found that Pearl had no greater interest in Frank's half of the farm than she had in any funds Frank might have deposited in a joint checking account. "In either case Pearl would get the interest if she survived Frank, but only if Frank refrained from exercising his unfettered power to withdraw (or partition)."[172]

Based on this comparison of Frank's right to partition to that of a general power of appointment, the court held that Pearl had received the farm as the result of two separate transfers. The first was the transfer of the undivided one-half interest in 1953, and the second was the transfer of the survivorship interest at Frank's death in 1978. Therefore, the time period in which Pearl could disclaim the half of the property she received at Frank's death started to run in 1978 and was governed by section 2518.[173]

The court's holding can be viewed in two ways. First, upon finding an inconsistency in the Treasury regulations, the court chose to apply the regulation which discussed general power of appointments[174] because the court found it more applicable and in line with the purpose of the statute than the regulation discussing joint tenancy interest.[175] The second

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[168]*Id.* at 1335.

[169]Treas. Reg. § 25.2518-2(c)(5) (1986) Example 9.

[170]*Kennedy*, 804 F.2d at 1335. *See also* Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See supra* text accompanying note 52 for language of the regulation.

[171]*Kennedy*, 804 F.2d at 1335.

[172]*Id.*

[173]*Id.* at 1336.

[174]Treas. Reg. § 25.2518-2(c)(3) (1986). *See supra* note 166 for text of regulation.

[175]Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See supra* text accompanying note 52 for language of regulation.

interpretation is that the court sufficiently distinguished Pearl's survivorship interest, based on Frank's power to partition, to remove it completely from the joint tenancy regulation[176] and to place it strictly under the general power of appointment regulation.[177] If the second interpretation is accepted, the holding is not in conflict with Treasury Regulation Section 25.2518-2(c)(4)(i);[178] the regulation simply does not apply in this case.

Under the second interpretation the regulation applying to joint tenancy would probably never be used because the right to partition is one of the common law rights associated with joint tenancy property and is present in most states where property is held as joint tenants with right of survivorship.[179] Courts would almost always be able to make the comparison, made by the court in *Kennedy*, that the right to partition is equivalent to a general power of appointment and, therefore, would apply the regulation that discusses general power of appointments rather than the one that addresses joint property interest. Although this interpretation makes the holding less controversial, the first interpretation appears to be the practical effect of the court's holding.

If the first interpretation is accepted, the holding is in direct conflict with Treasury Regulation Section 25.2518-2(c)(4)(i), which states that a disclaimer of a joint tenancy interest must be made within nine months of the creation of the tenancy.[180] The *Kennedy* court questioned the appropriateness of Treasury Regulation Section 25.2518-2(c)(4)(i) when it recognized that the regulation did not discuss the effects of a power to partition.[181] Because of the effect the right to partition has on the survivorship interest, the court found this omission suggested something was seriously wrong with the IRS's position in the regulation discussing joint property interests.[182]

The *Kennedy* court did not address directly its power to disregard a Treasury regulation (which is, implicitly, what the court did if the first interpretation is accepted). There are two types of Treasury regulations, "interpretative" and "legislative." A regulation promulgated pursuant to the Secretary's general authority under I.R.C. section 7805(a)

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[176] *Id.*

[177] Treas. Reg. § 25.2518-2(c)(3) (1986). *See supra* note 166 for text of regulation.

[178] Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See supra* text accompanying note 52 for language of regulation.

[179] Gwinn v. Commissioner, 287 U.S. 224, 228-29 (1932). *See supra* text accompanying note 69.

[180] Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See supra* text accompanying note 52 for language of regulation.

[181] *Kennedy v. Commissioner*, 804 F.2d 1332, 1335 (7th Cir. 1986).

[182] *Id.*

to "prescribe all needful rules and regulations for the enforcement of [the revenue laws],"[183] is an interpretative regulation. One that is issued under a specific delegation of authority by Congress in the statute itself is a legislative regulation and has the same effect as a valid statute.[184] Because Congress did not give such authority to the Commissioner in section 2518, all regulations concerning the section are interpretative. When applying an interpretative regulation, the court may substitute its judgment for the agency's.[185] Therefore, the court in *Kennedy* had the power to challenge the Treasury regulation.

The United States Supreme Court has held, however, that deference is owed to a regulation that " 'implement[s] the congressional mandate in some reasonable manner.' "[186] The Court has also held that, when challenging an interpretative regulation, a court is required to

> look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. . . . Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.[187]

The *Kennedy* court found that the regulation in question was not in harmony with the statute, and that the regulation was inconsistent with the other regulations under the statute.[188] The regulation was also not in line with the Congressional intent that the transfer which triggers the nine-month time period was to be a taxable transfer.[189] This is demonstrated by the regulation's requirement that the time period for disclaiming the survivorship interest begins to run at the creation of the tenancy[190] regardless of the fact that the transfer of the survivorship interest is not taxable at that time.

The regulation in question had been enacted less than three months before the *Kennedy* decision was rendered, and the court was the first to address disclaimer of joint property interest under the new regulation.

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[183] I.R.C. § 7805(a) (1987).

[184] Batterton v. Francis, 432 U.S. 416, 425 n.9 (1977).

[185] *See, e.g.*, General Electric Co. v. Gilbert, 429 U.S. 125 (1976); *Batterton*, 432 U.S. 416; *see also* Davis, Administrative Law Treatise § 7.8, at 36-43 (2d ed. 1979).

[186] United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982), (quoting United States v. Correll, 389 U.S. 299, 307 (1967)).

[187] National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979).

[188] *Kennedy*, 804 F.2d at 1335.

[189] *See supra* text accompanying notes 80-81.

[190] Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See supra* text accompanying note 52 for language of regulation.

Because the regulation had been enacted so recently there were very few arguments to support the regulation when looking at the other relevant considerations suggested by the Supreme Court when challenging a regulation. Therefore, the court's challenge and disregard of the Treasury Regulation Section 25.2518-2(c)(4)(i) was proper under the guidelines set by the Supreme Court.[191]

The *Kennedy* case recognized the reality of modern joint tenancy property and the Congressional intent behind section 2518 that it should be the taxable transfer that triggers the nine-month time period. However, it still relied heavily on the state law of Illinois in defining the property right to be disclaimed. The case brought to the forefront the need for Congress to take action to clarify the disclaimer of joint property interest if its intent to have a uniform federal disclaimer law that is not dependent on state or local law is to become a reality.

V. Post Kennedy Decisions

As of November, 1987, the Seventh Circuit is the only court of appeals that has addressed this issue. However, the Eighth Circuit will address the disclaimer of joint tenancy survivorship interest in the spring of 1988 in a case that is being appealed from the United States Tax Court. That case, *McDonald v. Commissioner*,[192] held that the disclaimer of jointly held property received from a decedent was not valid because transfer of the interest occurred upon the creation of the joint tenancies and the disclaimer was not made within a reasonable time.[193] The facts of the case, for practical purposes, are the same as those in *Kennedy*. The majority in *McDonald* found that *Jewett* applied and that the court in *Kennedy* had not sufficiently distinguished *Jewett*.[194] Although it recognized that North Dakota law permitted partition or severance of joint tenancies, the court did not find this a persuasive basis on which to distinguish *Jewett*. Instead, the court stressed the fact that in this case the joint tenant had not exercised his right to partition, and the right under North Dakota law only permitted it in limited circumstances and "certainly not at the whim of a joint tenant."[195]

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[191]*See supra* text accompanying note 187.

[192]McDonald v. Commissioner, 89 T.C. 293 (1987) *rev'd*, 823 F.2d 1494 (8th Cir. 1988). Immediately preceding publication of this Note, the Eighth Circuit handed down its opinion reversing the Tax Court in *McDonald*. The court relied on the reasoning of the Seventh Circuit in *Kennedy* in holding that the nine-month time period in section 2518 begins to run at the death of the joint tenant rather than at the creation of the joint tenancy as held by the Tax Court.

[193]*Id.* at 301.

[194]*Id.* at 299.

[195]*Id.* at 300.

This reasoning is flawed. A joint tenant either does or does not have a right to partition. Just because he chooses not to exercise the right during his lifetime does not mean it did not exist and would not have affected the property if it had been exercised. Based on this reasoning, however, the majority held, as did the lower court in *Kennedy*, that the survivorship interest was a "contingency that [was] not . . . materially different than the contingency faced by the disclaiming taxpayer in *Jewett*."[196]

A strong dissenting opinion disagreed with the majority's application of *Jewett*.[197] They agreed with the Seventh Circuit's analysis in *Kennedy* and summarized it as follows:

> Jewett interests become *irrevocable* with the creation of the trust to Mrs. Jewett's death, whereas Frank Kennedy's gift to Pearl, i.e., the right of Pearl to receive Frank's interest when Frank died, was *revocable* until Frank's death, when it became *irrevocable*. Under section 2518(b)(2)(A), taxpayer then had 9 months within which to disclaim, which she did.[198]

McDonald will give the Eighth Circuit a chance to join the Seventh Circuit in recognizing the realities of modern joint tenancy property and also to continue to set precedent that will further the Congressional intent behind section 2518. If the Eighth Circuit chooses not to hold with the Seventh Circuit, then it will be for the Supreme Court to settle the dispute among the circuits concerning the disclaimer of joint property interest.[199]

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[196] *Id.* (quoting Kennedy v. Commissioner, 51 T.C.M. 232, 233, *rev'd*, 804 F.2d 1332 (7th Cir. 1986)). "A proper appeal in this case would lie in the Eighth Circuit not the Seventh Circuit. Accordingly, we are not bound by the Seventh Circuit's opinion in *Kennedy*." *McDonald*, 89 T.C. at 296 n.11.

[197] *McDonald*, 89 T.C. at 308 (Nims, J., dissenting). Six judges joined the dissent while there were ten siding with the majority. The second dissenting opinion of Judge Parr discussed briefly the treatment of tenants by the entirety. He wrote that because "divorce or annulment generally terminates the tenancy by the entirety and transforms it into a tenancy in common, with each spouse holding an undivided one-half interest," 4A R. Powell, The Law of Real Property, ¶ 624[3] (1986), he would treat both tenancies by the entirety and joint tenancies the same. *McDonald*, 89 T.C. at 310 (Parr, J., dissenting). This Note did not address disclaimers of tenancy by the entirety interest between spouses, but since they, too, can be partitioned by divorce or annulment, the same reasoning as applied in *Kennedy* would also apply to tenancy by the entirety interest.

[198] *McDonald*, 89 T.C. at 308-09 (Nims, J., dissenting).

[199] For another post *Kennedy* case addressing disclaimers of joint tenancy interest under section 2518, see Estate of Dancy v. Commissioner, 89 T.C. 550 (1987). This court disagreed with the *Kennedy* court and cited *McDonald* as authority. The case occurred in North Carolina, which has no state disclaimer laws for joint tenancy property, therefore making it distinguishable from *Kennedy* and limited by its facts. *See also* Estate of

VI. Conclusion

The *Kennedy* case has brought to the forefront the issue of when the time period begins to run for the disclaimer of the survivorship interest in joint tenancy property. By allowing such a disclaimer to be made by the surviving joint tenant within nine months of the deceased joint tenant's death,[200] rather than nine months from the creation of the tenancy as required by the Treasury Regulation,[201] the holding in *Kennedy* has given owners of joint tenency property an effective post mortem estate planning tool that will allow them to reduce their tax burden when passing their property to the next generation. Disclaimers of property at death to avoid taxes is not a new concept. The *Kennedy* holding merely dispenses with discrimination between similar property ownership forms, by allowing joint tenancy property owners the same rights that tenants in common property owners enjoy under present disclaimer laws. It is also in line with recent legislation to help alleviate the large estate tax burden on farm families when passing their farms on to the next generation.[202]

Congress made changes in the federal disclaimer law in 1976 and again in 1981. Three major goals in making these changes were: 1) to create a uniform federal disclaimer law that was not dependent on local or state law; 2) to substitute a nine-month period for the "reasonable time" period in the previous statute; and 3) to define the transfer from which this time period begins to run as a taxable transfer.[203] Despite Congress' efforts, there is still a lack of uniform treatment of federal disclaimer law among the courts, particularly with respect to joint tenancy property interest and what constitutes the transfer from which the nine-month time period begins.

The IRS is partly to blame, because in formulating Treasury Regulations under section 2518, it has failed to recognize the reality of modern joint tenancy property that an interest *does pass at death* to the surviving tenant,[204] and the Congressional intent that it is a taxable transfer from which the nine-month time period begins to run.[205]

Lamoureux v. Iowa Dept. of Rev., 412 N.W.2d 628 (Iowa 1987). This case only addresses Iowa disclaimer law. However, it cites *Kennedy* as support for interpreting their statute as allowing disclaimer of the survivorship interest by the survivor if made within nine months of the death of the deceased joint tenant.

[200]*Kennedy*, 804 F.2d at 1336.

[201]Treas. Reg. § 25.2518-2(c)(4)(i) (1986). *See supra* text accompanying note 52 for language of regulation.

[202]*See supra* text accompanying notes 115-16.

[203]*See supra* text accompanying notes 77-116.

[204]*See supra* text accompanying notes 66-76.

[205]*See supra* text accompanying notes 89-90.

The *Kennedy* court recognized the inconsistency of the regulation with respect to Congressional intent and the realities of modern joint tenancy property. The court chose not to apply the regulation, allowing Mrs. Kennedy's disclaimer of the survivorship interest within nine months of her husband's death.[206]

At this point, three possible forms of action can be taken to resolve this conflict created by the *Kennedy* decision. Congress could add amendments to section 2518 that specifically address joint tenancy property and make clear what its intended treatment of such interests are.[207] Second, but unlikely because of the present litigation in which the IRS is involved,[208] the IRS could issue a new regulation on joint property more in line with Congressional intent and the realities of modern joint tenancy property. Third, the conflict could be resolved by the courts. If the Eighth Circuit aligns itself with *Kennedy* in the *McDonald* case, although it might not settle the issue in favor of *Kennedy* in other circuits, it would certainly bolster the support for the *Kennedy* application of section 2518. If the Eighth Circuit holds against *Kennedy* in the *McDonald* case, there would be a split among the circuits. At that point, if Congress or the IRS has not taken any action, the Supreme Court would have the opportunity to address and settle the issue of when the nine-month time period in section 2518 begins to run when disclaiming the survivorship interest of a joint tenancy—at the creation of the tenancy or at the death of one of the joint tenants.

If the Supreme Court has the opportunity to decide this conflict, it should recognize the realities of modern joint tenancy property and the Congressional intent behind section 2518. In doing so, the Court should affirm the holding in *Kennedy* which allows the qualified disclaimer of the survivorship interest in jointly held property if made within nine months of the deceased joint tenant's death.

Gary L. Chapman

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[206] *Kennedy v. Commissioner*, 804 F.2d 1332, 1336 (7th Cir. 1986).

[207] For a recommended draft of an amendment reflecting the view that the survivorship interest should be disclaimable within nine months of the deceased joint tenant's death, see Uchtmann, *supra* note 47, at 355.

[208] *See supra* text accompanying notes 192-99.

Medicare Provider Reimbursement Disputes: Mapping the Contorted Borders of Administrative and Judicial Review

I. Introduction

This nation spent 458 billion dollars—nearly eleven percent of the Gross National Product—on health care in 1986.[1] The federal government financed twenty-five percent of that amount through the Medicare and Medicaid programs.[2] Most of Medicare's expenditures were paid directly to health care providers, primarily hospitals, as reimbursement for providing care and treatment to Medicare beneficiaries.[3] The Department of Health and Human Services [HHS] administers the Medicare program, and the Secretary of HHS has broad authority to promulgate rules and regulations affecting Medicare.[4] Health care providers have an enormous stake in these rules, particularly those affecting reimbursement amounts. Recent figures indicate that the average acute-care hospital receives twenty-eight percent of its revenue directly from Medicare.[5] Yet obtaining some form of review of the regulations and decisions relating to payment issues has proved to be difficult for Medicare providers. The jurisdictional grants of the Medicare act which provide for administrative and judicial review of provider disputes have been extensively litigated, often with conflicting results.[6] If the present state of the availability of review is best described as being discordant, the future must be characterized as sharply restricted. Dramatic changes in the substantive law governing inpatient reimbursement have been specifically put beyond the scope of administrative and judicial oversight.[7]

The health care provider dissatisfied with its Medicare reimbursement must follow the procedures for obtaining review or face a collateral

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[1]*Currents*, HOSPITALS, August 5, 1987, at 22.

[2]*Id.*

[3]Hospitals receive approximately 70% of all Medicare reimbursements. UNITED STATES BUDGET IN BRIEF - FISCAL YEAR 1987, at 81 (1986).

[4]42 U.S.C. § 405(a) (1982).

[5]Kinney, *The Medicare Appeals System for Coverage and Payment Disputes: Achieving Fairness in a Time of Constraint*, 1 ADM. L.J. 1, 5 (1987) (citing OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES, FY 1987, H.R. DOC. NO. 143, 99th Cong., 2d Sess. 5-108 (1986)).

[6]Informal research indicates that almost every federal case involving a challenge by a provider to a reimbursement determination has required some discussion as to the availability of jurisdiction. Many cases deal exclusively with jurisdiction. There are approximately 300 federal decisions interpreting 42 U.S.C. § 1395oo, the United States Code section governing appeal of reimbursement determinations.

[7]*See infra* notes 158-70 and accompanying text.

attack on his right to litigate. This Note examines the jurisdictional parameters governing administrative and judicial review of Medicare provider reimbursement disputes. The Note deals exclusively with the institutional provider[8] receiving reimbursement under Medicare Part A.[9] After an introductory overview to the Medicare program in general, the jurisdictional statutes and decisions will be reviewed, first for availability of administrative review, and then for access to judicial review. Fact patterns that have met with consistent jurisdictional results will be described, but the principal focus will be on those aspects of the statutes on which the courts have failed to reach agreement. Those statutory provisions that have been specifically precluded from administrative and judicial review will be explained. Building upon this analytical foundation of statutory interpretation and prior case law, the Note will assess the likely direction of future jurisdictional issues. The concluding section explains why a broad interpretation of Medicare jurisdictional statutes is both needed by Medicare service providers and consistent with recent Supreme Court holdings.

At issue in this analysis is the authority to challenge how billions of federal dollars are spent. At a practical level, the jurisdictional problems discussed herein are of critical importance to the fiscal well-being of the hospitals seeking review. One study indicated that the average size of a disputed Medicare payment at the administrative level of adjudication during 1986 was $400,000.[10] The Secretary has shown he intends to use the limited availability of review to his advantage against any claim where there may be a colorable jurisdictional issue. Given the sweeping nature of recent and proposed changes to Medicare reimbursement regulations, the health care provider must have an understanding of the jurisdictional roadblocks that may be encountered in litigation, and how to overcome them.

II. An Overview of Medicare from the Provider's Perspective

Medicare was enacted in 1965 as part of the Social Security Act.[11] It is essentially a federally subsidized health insurance program administered by the Department of Health and Human Services.[12] Generally,

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[8]*See* 42 U.S.C. § 1395x(u) (Supp. III 1985) for the definition of a qualifying institutional provider.

[9]*See infra* notes 18-20 and accompanying text for an overview of Medicare Part A.

[10]*See* study reported in Burda, *Ganeles Braces the PRRB for Change*, Hospitals, January 5, 1987, at 44.

[11]42 U.S.C. §§ 1395-1395zz (1982 & Supp. III 1985).

[12]In the interest of maintaining consistency with the nomenclature used in the cases, this Note will refer to either the HHS or the Secretary when discussing the administrative responsibility for Medicare.

enrollment in Medicare is limited to citizens aged sixty-five and older, and to certain disabled individuals.[13] Medicare is divided into two distinct programs: Part A and Part B. The Part B program is made available on a voluntary basis, and is set up similarly to a commercial insurance company, providing insurance coverage primarily for physician fees.[14] Although the jurisdictional borders of Part B regulations have been extensively litigated, that topic will not be addressed here.[15] While some significant interpretations of the Medicare jurisdictional statutes have involved beneficiary claims, that category of claim will not be discussed.[16] This Note focuses on Medicare Part A jurisdiction from the institutional health care provider perspective.[17] Medicare Part A provides insurance for hospital and certain post-hospital expenses at no cost to the eligible enrollee.[18] Only a hospital or other qualified provider of services is eligible to receive payments under the Part A program,[19] and the provider must agree not to charge the Medicare beneficiary for services received.[20]

Prior to 1983, hospitals were entitled to reimbursement from the government for the actual, reasonable costs of furnishing care to Medicare beneficiaries.[21] At that time, and still today, each provider submitted a year-end "cost report" detailing the costs associated with treating Medicare patients.[22] In 1983, Congress enacted provisions creating a prospective, rather than cost based system for reimbursing providers for inpatient services.[23] This new payment system[24] was phased in over a four year period ending in 1987.[25] For the most part, reimbursement for inpatient services is no longer based on the hospital's costs incurred in treating Medicare beneficiaries. However, reimbursement for psychiatric hospitals, outpatient services, capital expenses, bad debt and medical education is still based on the cost reporting system.[26]

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[13]42 U.S.C. §§ 1395c, 1395o (1982 & Supp. III 1985).

[14]*Id.* § 1395j, 1395k(a).

[15]Numerous decisions bantered around the availability of judicial review regarding Part B determinations until the recent Supreme Court decision in Bowen v. Michigan Academy of Family Physicians, 476 U.S. 667 (1986). *See infra* notes 187-93 and accompanying text.

[16]Heckler v. Ringer, 466 U.S. 602 (1984); Weinberger v. Salfi, 422 U.S. 749 (1975).

[17]*See supra* note 8.

[18]42 U.S.C. § 1395d(a)-(c) (1982).

[19]42 U.S.C. § 1395f(a) (1982 & Supp. III 1985).

[20]42 U.S.C. § 1395cc(a)(1) (1982).

[21]*Id.* § 1395f(b)(1).

[22]42 C.F.R. §§ 413.20, 413.24(f) (1986). The cost report itself is a lengthy document often containing hundreds of pages in the form of schedules and worksheets.

[23]42 U.S.C. § 1395ww(d) (Supp. III 1985).

[24]*See infra* notes 158-62 and accompanying text for a brief overview to the prospective payment system.

[25]42 U.S.C. § 1395ww(d)(1)(C) (Supp. III 1985).

[26]*Id.* §§ 1395ww(a)(4), 1395ww(d)(1)(B).

Although the HHS administers the program and, through the Secretary, has the authority to promulgate rules and render decisions, the daily supervision of the Medicare program is performed at the local level by large insurance companies acting under contract as "fiscal intermediaries."[27] The intermediary is the first line of administrative authority for the resolution of any type of Medicare dispute.[28]

The Medicare provider files the annual cost report with the assigned intermediary within three months following the end of the provider's fiscal year.[29] The intermediary audits the report and issues a Notice of Program Reimbursement, explaining any adjustments made to the provider's cost report.[30] A provider dissatisfied with the amount of reimbursement may request administrative review of his claim. A provider still dissatisfied following an administrative hearing may bring suit in federal court. Because all disputes must first begin at the administrative level, this Note's discussion begins with an analysis of the availability of administrative review. The inability to gain a jurisdictional foothold at this level will preclude the possibility of later judicial review.

III. Administrative Review

Provider dissatisfaction with some aspect of its Medicare reimbursement might be caused by a regulation thought to be invalid, or by a perceived inaccuracy in the application of a regulation by the intermediary. To obtain and preserve the right to dispute the issue, there are specific procedures and time-tables that the provider must observe.

In 1972, Congress created the Provider Reimbursement Review Board [Board] as a forum for administrative review of intermediary determinations.[31] The Board adjudicates disputes arising from provider dissatisfaction with the amount of Medicare reimbursement due, or the timeliness of an intermediary determination.[32] Section 1395oo of title 42, United States Code, establishes the Board and delineates its authority.[33] It also

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[27]*Id.* § 1395h.

[28]42 C.F.R. §§ 405.1803(a), 405.1809 (1986).

[29]*See generally* 42 U.S.C. § 1395oo(a)(1) (1982 & Supp. III 1985).

[30]*See generally id.* § 1395oo(f).

[31]*See* S. Rep. No. 1230, 92d Cong., 2d Sess. 249 (1972).

[32]42 U.S.C. § 1395oo(a)(1) (1982 & Supp. III 1985).

[33]*Id.* §§ 1395oo(a) and (d), which establish the Board and delineate its authority are reproduced below:

> (a) Establishment. Any provider of services which has filed a required cost report within the time specified in regulations may obtain a hearing with respect to such cost report by a Provider Reimbursement Review Board (hereinafter referred to as the "Board") which shall be established by the Secretary in accordance with subsection (h) of this section and (except as provided in subsection (g)(2)

establishes the criteria for the availability of judicial review of provider disputes.[34]

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of this section) any hospital which receives payments in amounts computed under subsection (b) or (d) of section 1395ww of this title and which has submitted such reports within such time as the Secretary may require in order to make payment under such section may obtain a hearing with respect to such payment by the Board, if—

(1) such provider—

(A) (i) is dissatisfied with a final determination of the organization serving as its fiscal intermediary pursuant to section 1395h of this title as to the amount of total program reimbursement due the provider for the items and services furnished to individuals for which payment may be made under this subchapter for the period covered by such report, or

(ii) is dissatisfied with a final determination of the Secretary as to the amount of the payment under subsection (b) or (d) of section 1395ww of this title,

(B) has not received such final determination from such intermediary on a timely basis after filing such report, where such report complied with the rules and regulations of the Secretary relating to such report, or

(C) has not received such final determination on a timely basis after filing a supplementary cost report, where such cost report did not so comply and such supplementary cost report did so comply,

(2) the amount in controversy is $10,000 or more, and

(3) such provider files a request for a hearing within 180 days after notice of the intermediary's final determination under paragraph (1)(A)(i), or, with respect to appeals under paragraph (1)(A)(ii), 180 days after notice of the Secretary's final determination, or with respect to appeals pursuant to paragraph (1)(B) or (C), within 180 days after notice of such determination would have been received if such determination had been made on a timely basis. . . .

(d) Decisions of Board. A decision by the Board shall be based upon the record made at such hearing, which shall include the evidence considered by the intermediary and such other evidence as may be obtained or received by the Board, and shall be supported by substantial evidence when the record is viewed as a whole. The Board shall have the power to affirm, modify, or reverse a final determination of the fiscal intermediary with respect to a cost report and to make any other revisions on matters covered by such cost report (including revisions adverse to the provider of services) even though such matters were not considered by the intermediary in making such final determination.

[34]42 U.S.C. § 1395oo(f) (1982 & Supp. 1985) establishes the criteria for judicial review and is set out below:

(f) Finality of decision; judicial review; determinations of Board authority; jurisdiction; venue; interest on amount in controversy.

(1) A decision of the Board shall be final unless the Secretary, on his own motion, and within 60 days after the provider of services is notified of the Board's decision, reverses, affirms, or modifies the Board's decision. Providers shall have the right to obtain judicial review of any final decision

A. The Jurisdiction of the Board

The Board is authorized to act in an appellate capacity, in that it may "affirm, modify, or reverse a final determination of the fiscal intermediary with respect to a cost report."[35] It also can act as a fact-

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of the Board, or of any reversal, affirmance, or modification by the Secretary, by a civil action commenced within 60 days of the date on which notice of any final decision by the Board or of any reversal, affirmance, or modification by the Secretary is received. Providers shall also have the right to obtain judicial review of any action of the fiscal intermediary which involves a question of law or regulations relevant to the matters in controversy whenever the Board determines (on its own motion or at the request of a provider of services as described in the following sentence) that it is without authority to decide the question, by a civil action commenced within sixty days of the date on which notification of such determination is received. If a provider of services may obtain a hearing under subsection (a) of this section and has filed a request for such a hearing, such provider may file a request for a determination by the Board of its authority to decide the question of law or regulations relevant to the matters in controversy (accompanied by such documents and materials as the Board shall require for purposes of rendering such determination). The Board shall render such determination in writing within thirty days after the Board receives the request and such accompanying documents and materials, and the determination shall be considered a final decision and not subject to review by the Secretary. If the Board fails to render such determination within such period, the provider may bring a civil action (within sixty days of the end of such period) with respect to the matter in controversy contained in such request for a hearing. Such action shall be brought in the district court of the United States for the judicial district in which the provider is located (or, in the action brought jointly by several providers, the judicial district in which the greatest number of such providers are located) or in the District Court for the District of Columbia and shall be tried pursuant to the applicable provisions under chapter 7 of title 5, notwithstanding any other provisions in section 405 of this title. Any appeal to the Board or action for judicial review by providers which are under common ownership or control or which have obtained a hearing under subsection (b) of this section must be brought by such providers as a group with respect to any matter involving an issue common to such providers.

(2) Where a provider seeks judicial review pursuant to paragraph (1), the amount in controversy shall be subject to annual interest beginning on the first day of the first month beginning after the 180-day period as determined pursuant to subsection (a)(3) of this section and equal to the rate of return on equity capital established by regulation pursuant to section 1395x(v)(1)(B) of this section and in effect at the time the civil action authorized under paragraph (1) is commenced, to be awarded by the reviewing court in favor of the prevailing party.

(3) No interest awarded pursuant to paragraph (2) shall be deemed income or cost for the purposes of determining reimbursement due providers under this chapter.

[35] 42 U.S.C. § 1395oo(d) (1982).

finder, by examining witnesses and allowing the presentation of evidence at the Board hearing.[36] A determination by the Board is considered final, unless the Secretary exercises the statutory right to overrule the Board,[37] or unless the decision is overturned on appeal by a federal district court.[38] The Board is bound by the rulings of the Secretary in making its determinations.[39]

The Board does not have the authority to consider questions of law regarding the validity of a rule or regulation promulgated by the Secretary or Congress.[40] Although provision has been made to allow for expedited judicial review when the Board has no authority to decide an issue, all claims still must be initially submitted to the Board, so that it can determine in the first instance whether it has authority to resolve the dispute.[41] But the Board itself has other jurisdictional limitations, as well as some procedural requisites that have been interpreted as being jurisdictional in nature. These limitations are discussed in the following sections.

B. Amount in Controversy

The first relevant determination applicable to obtaining a hearing before the Board is the amount in controversy. Generally, the Board is not authorized to grant a hearing when the amount in controversy is less than $10,000.[42] However, review would be allowed even where the amount in controversy is less than $10,000 if the provider can effectuate a group appeal. If all the providers' claims in the group "involve a common question of fact or interpretation of law or regulations," then a group appeal could be taken before the Board, as long as all the other jurisdictional requirements have been met and the aggregate amount in controversy exceeds $50,000.[43]

The courts would probably adopt a liberal interpretation of this amount in controversy requirement. This would be consistent with general

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[36]42 U.S.C. § 1395oo(c) (Supp. III 1985).

[37]42 U.S.C. § 1395oo(f) (1982 & Supp. III 1985). *See also* note 34.

[38]*Id.*

[39]42 C.F.R. § 405.1867 (1986).

[40]42 U.S.C. § 1395(f)(1) (Supp. III 1985); *see also* Hospital Ass'n v. Secretary of HHS, 820 F.2d 533, 539 (1st Cir. 1987).

[41]*See infra* notes 110-16 and accompanying text for a discussion of the 1980 amendments providing for expedited judicial review.

[42]42 U.S.C. § 1395oo(a)(2) (Supp. III 1985). If the amount in controversy is less than $10,000 but more than $1000, the provider may obtain a hearing with the intermediary. 42 C.F.R. § 1809(b) (1986). The details of this type of administrative hearing are explained in 42 C.F.R. §§ 1809-1833 (1986).

[43]42 U.S.C. § 1395oo(b) (Supp. III 1985).

federal law.[44] And in one of the few cases where the Secretary challenged the Board's jurisdiction on this point, the hospitals involved were permitted to aggregate cost reports for more than one year in order to meet the $50,000 requirement.[45]

C. Timeliness of Request

Section 1395oo also requires that the provider file a request for a hearing within 180 days following notice of the intermediary's final determination of total program reimbursement.[46] This provision has been generally accepted to be jurisdictional in nature.[47] Thus, a provider wishing to take advantage of a recent favorable court decision or in any way challenge his reimbursement for a given cost year must act promptly or lose the right to review.

This restriction seems simple enough, but has been made complicated by a federal regulation which gives the Board the authority to extend the time limit for accepting appeals for up to three years on a showing of "good cause."[48] This ruling conflicts with the general rule that administrative bodies do not have the authority to extend the jurisdictional limitations imposed by Congress.[49] For this reason, the appellate court in *St. Joseph's Hospital v. Heckler*[50] found the regulation to be illegal and without force. Thus, health care providers in the Eighth Circuit may not request an extension to appeal. But in the Ninth Circuit, the appellate court relied on the general rule that an agency interpretation will be given deference if found to be a permissible construction of the statute being construed,[51] and upheld the validity of the rule in *Western*

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[44]The leading case on liberally construing federal amount in controversy requirements is St. Paul Mercury Indem. v. Red Cab Co., 303 U.S. 283 (1938). In this oft-cited case, the Court stated that it must be apparent to a legal certainty that the claim is really for less than the jurisdictional amount in order to dismiss the case.

[45]Cleveland Mem. Hosp., Inc. v. Califano, 594 F.2d 993 (4th Cir. 1979).

[46]42 U.S.C. § 1395oo(a)(3) (Supp. III 1985). Notice, in this context, has been interpreted to occur when the provider actually receives notice of a determination, and not when the determination is made. Sun Towers, Inc. v. Heckler, 725 F.2d 315 (5th Cir.), *cert. denied*, 466 U.S. 936 (1984).

[47]*See* St. Joseph's Hosp. v. Heckler, 786 F.2d 848, 853 (8th Cir. 1986); V.N.A. of Greater Tift County v. Heckler, 711 F.2d 1020 (11th Cir. 1983); Miami Gen. Hosp. v. Bowen, 652 F. Supp. 812, 814 (S.D. Fla. 1986).

[48]42 C.F.R. § 1841(b) (1986).

[49]*See generally* Citizens State Bank v. FDIC, 751 F.2d 209, 217 (8th Cir. 1984); Atchison, T.&S.F. R.R. v. Interstate Commerce Comm'n, 607 F.2d 1199, 1203 (7th Cir. 1979).

[50]786 F.2d 848, 853 (1986).

[51]*See, e.g.*, Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984); Blum v. Bacon, 457 U.S. 132, 141 (1982); Memorial Hosp. v. Heckler, 706 F.2d 1130, 1134 (11th Cir. 1983).

Medical Enterprises, Inc. v. Heckler.[52] Noting that the language of section 1395oo states that a provider "may" obtain a hearing if the jurisdictional requirements are met, the court found this language ambiguous enough to permit the Board to waive the 180 day requirement if it so chose.[53]

Although the regulation does not seem unreasonable, the Eighth Circuit's holding that the 180 day limitation is not subject to discretionary extension is the better rule of law and makes more practical sense. As the *St. Joseph's* court noted, a House report discussing this provision states that an "appeal *must* be filed within 180 days. . . ."[54] Congress could have avoided the use of the word "must" or inserted a clause indicating that appeal may be taken within such time as the Secretary may allow.[55] Further, it is axiomatic in federal courts that the issue of subject matter jurisdiction may not be waived.[56] There is no justification for not applying a similar rule to administrative bodies acting in a judicial capacity. From a practical standpoint given the extensive backlog of appeals now pending before the Board, it is unlikely that a provider could show convincing reasons for missing a filing deadline.[57]

Because the Supreme Court will probably never entertain argument on this question, the issue will probably be adjudicated on a case by case basis. Clearly, there is a substantial risk involved in allowing the 180 day filing deadline to pass.

D. Matters Covered on a Cost Report

Another issue that has caused dissent among the courts is the question of what constitutes a matter covered on a cost report. Generally, section 1395oo provides that any health service provider who has filed a timely cost report may obtain a hearing before the Board "with respect to such cost report . . . [if the provider is] dissatisfied with a final determination of . . . [the intermediary] as to the amount of total program reimbursement due . . . for the period covered by the report . . . ."[58]

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[52] 783 F.2d 1376, 1379-80 (9th Cir. 1986).

[53] *Id.* at 1380.

[54] 786 F.2d at 851 (quoting H.R. REP. NO. 231, 92d Cong., 2d Sess., *reprinted in* 1972 U.S. CODE CONG. & ADMIN. NEWS 4989, 5094).

[55] *Id.*

[56] FED. R. CIV. P. 12(h); *see also* Laffey v. Northwest Airlines, Inc., 567 F.2d 429, 474 (D.C. Cir. 1976), *cert. denied*, 434 U.S. 1086 (1978).

[57] In an interview early in 1987, Paul Morton Ganeles, the chairman of the Provider Reimbursement Review Board, stated that the Board was "set up to handle a caseload ten percent of what we have." At that time, the Board had 3,259 pending appeals. Burda, *Ganeles Braces the PRRB for Change*, HOSPITALS, January 5, 1987, at 44.

[58] 42 U.S.C. § 1395oo(a) (1982 & Supp. III 1985). The statute also authorizes the provider to obtain a hearing before the Board with respect to the cost report if the provider has not received a timely determination by the intermediary. *See supra* note 33 for a complete text of section 1395oo(a).

This section further provides that the Board has the authority to "affirm, modify, or reverse a final determination of the fiscal intermediary with respect to a cost report and to make any other revisions on matters covered by such cost report . . . even though such matters were not considered by the intermediary in making such final determination."[59]

In the routine Board dispute, then, a provider with a dispute involving an amount in controversy in excess of $10,000 files for a hearing within 180 days of receiving the Notice of Program Reimbursement. The provider's complaint will center on some aspect of an expense claimed on the cost report but denied by the intermediary in its final reimbursement determination. But an important issue arises when a provider disagrees with a regulation, but files the cost report in accordance with the disputed rule. By strictly conforming to cost reporting regulations, many providers lost their right to administrative and judicial review. The general reasoning of the Board in these cases was that by not including the disputed cost on the cost report, there was no "final determination" of the intermediary "with respect to" a cost report for the Board to review.[60] In 1979, the Board began to refuse to accept jurisdiction to hear appeals concerning costs that had been "self-disallowed" from the cost report.[61]

Until April 4, 1988, when the Supreme Court decided *Bethesda Hospital v. Bowen*,[62] the self-disallowance issue had been frequently litigated and with divergent results. The leading opinion on this issue since 1984 had been *Athens Community Hospital v. Schweiker*.[63] In that case, the provider group had argued unsuccessfully that section 1395oo(d) gave the Board the authority to review issues "even though such matters were not considered by the intermediary in making such final deter-

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[59]42 U.S.C. § 1395oo(d) (1982). *See supra* note 33 for the complete text.

[60]42 U.S.C. § 1395oo(a) (1982 & Supp. III 1985). *See* University of Cincinnati v. Secretary of HHS, 809 F.2d 307, 310 (6th Cir. 1987); Athens Community Hosp. v. Schweiker, 743 F.2d 1, 8 (D.C. Cir. 1984).

[61]Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435 (11th Cir. 1987), involved a hospital that had "self-disallowed" costs. An attorney in that case has criticized the Board for penalizing hospitals that were attempting to comply with Medicare rules and regulations, especially since the hospitals were never made aware of the implications of omitting disputed costs from their cost reports. "The PRRB first used the policy in 1979 and acted like everyone knew about it. Hospitals were innocently led to slaughter." Burda, *"Self-disallowed" Costs: Issue to High Court?*, Hospitals, July 20, 1987 at 60.

[62]108 S. Ct. 1255 (1988), *rev'g* 810 F.2d 558 (6th Cir. 1987).

[63]743 F.2d 1 (D.C. Cir. 1984). This case is important for two reasons. First, the opinion, written by Judge Robert Bork, is carefully reasoned and well written. Second, District of Columbia Circuit decisions are highly influential because providers have the option of litigating either in their home district court or in the District of Columbia court. 42 U.S.C. § 1395oo(f) (1982 & Supp. III 1985).

mination."[64] The District of Columbia Court of Appeals held that in order for jurisdiction to exist, a claim for reimbursement must be made either by directly claiming the disputed cost on the report or by appending a statement to the cost report claiming entitlement to reimbursement for the disputed cost.[65] This line of reasoning had been followed in decisions by the Courts of Appeals for the Fourth[66] and Sixth circuits.[67] But more recent appellate decisions had shown a willingness to find jurisdiction in these self-disallowed cost situations.[68] The Supreme Court granted certiorari in *Bethesda Hospital* to resolve what had become a conflict among the Courts of Appeals.[69]

In the *Bethesda Hospital* case, a group of hospitals sought to challenge a regulation governing reimbursement for medical malpractice insurance costs.[70] But two of the plaintiff hospitals had filed their cost reports in accordance with the regulation they sought to challenge, and the Board refused to hear their claims.[71] The district court ordered the Board to accept jurisdiction but that decision was reversed by the Sixth Circuit Court of Appeals.[72]

The Supreme Court reversed, holding that when a provider self-allows a cost in accordance with a regulation, the right to challenge the validity of the rule and the reimbursement amount for that cost is not lost.[73] The decision was predicated on Justice Kennedy's interpretation of the language of section 1395oo(a)(1)(A)(i), which requires that a provider must be "dissatisfied with a final determination of . . . its fiscal intermediary . . . ."[74] The Court characterized as "strained" the Secretary's view that a provider cannot be dissatisfied with an intermediary's decision to reimburse the amount indicated in the cost report.[75] The Court stated:

> It is clear, however, that the submission of a cost report in full compliance with the unambiguous dictates of the Secretary's rules does not, by itself, bar the provider from claiming dis-

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[64] *Athens*, 743 F.2d, at 5, (quoting 42 U.S.C. § 1395oo(d) (Supp. III 1985)). *See supra* note 33 for the complete text of this statute.

[65] *Athens*, 743 F.2d at 10.

[66] Community Hosp. v. HHS, 770 F.2d 1257 (4th Cir. 1985).

[67] Baptist Hosp. East v. Secretary of HHS, 802 F.2d 860 (6th Cir. 1986).

[68] *See* Adams House Health Care v. Heckler, 817 F.2d 587 (9th Cir. 1987); Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435 (11th Cir. 1987).

[69] Bethesda Hosp. v. Bowen, 108 S. Ct. 1255, 1258 (1988).

[70] *Id.* at 1257.

[71] *Id.*

[72] *Id.*

[73] *Id.* at 1258.

[74] *Id.* (quoting 42 U.S.C. § 1395oo(a)(1)(A)(i) (Supp. III 1985)).

[75] *Id.*

> satisfaction with the amount of reimbursement allowed by those regulations . . . . We conclude that petitioners could claim dissatisfaction, within the meaning of the statute, without incorporating their challenge in the cost reports filed with their fiscal intermediaries.[76]

The Court found further support for its position in section 1395oo(d), which permits the Board to "make any other revisions on matters covered by such cost report . . . even though such matters were not considered by the intermediary in making such final determinations."[77]

While the *Bethesda Hospital* decision settled the question of self-disallowed costs when a regulation is being challenged, the Court did not address whether a provider could obtain Board review of reimbursement determinations when providers simply fail to request reimbursement to which they are entitled. But the Court did hint that a provider in that situation would "stand on different ground" than the petitioners in *Bethesda Hospital.*[78] Moreover, the Eleventh Circuit Court of Appeals had already taken the position that although self-disallowance in compliance with regulations does not create a jurisdictional bar,[79] failure to include allowable costs does preclude Board jurisdiction.[80] Following *Bethesda Hospital*, it seems likely that the other federal courts will adopt the same position.

E. A Final Determination of the Intermediary

The question of what constitutes a final determination by the intermediary has also caused conflict among federal courts. As a general rule, issuance of a Notice of Program Reimbursement satisfies the requirement of a final determination by the intermediary.[81] However, instances have arisen in the past, and are likely to occur again, where an intermediary must make a determination affecting provider payment prior to the issuance of the reimbursement notice. The question then arises over whether the Board can hear an appeal on this intermediate determination, or whether the provider must await the formal issuance of the reimbursement notice. Although most courts which have addressed this question have allowed the Board to hear these appeals, some contrary

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[76] *Id.* at 1258-59.

[77] *Id.* at 1259 (quoting 42 U.S.C. § 1395oo(d) (1982)).

[78] *Id.*

[79] Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435 (11th Cir. 1987).

[80] North Broward Hosp. Dist. v. Bowen, 808 F.2d 1405 (11th Cir. 1987).

[81] *See* 42 U.S.C. § 1395oo(a)(1)(A) (Supp. III 1985); Charter Medical Corp. v. Bowen, 788 F.2d 728, 733 (11th Cir. 1986).

authority exists. This issue has arisen in the context of amendments to section 1395oo, adopted in 1983 as part of the shift to prospective reimbursement.[82]

At the same time Congress was overhauling the substantive law governing Medicare reimbursement in 1983, conforming amendments were made to the jurisdictional provisions as well.[83] One of the amendments permitted a hearing before the Board if the provider was "dissatisfied with a final determination of the Secretary as to the amount of payment" under the new prospective reimbursement system.[84] Under the prospective payment system, intermediaries were required to make a preliminary determination of each hospital's current average cost of treatment of Medicare patients, so this amount could be blended into the prospective payment amount.[85] In reliance on the conforming amendments, the Board began accepting jurisdiction to review provider complaints regarding intermediary determinations of average cost.[86] The Secretary then issued a ruling [HCFAR 84-1] stating that an intermediary's estimation of base year costs is not a final determination of program reimbursement and accordingly, the Board is without jurisdiction to review the intermediary's determination until after the issuance of a reimbursement notice for the first year under the new system.[87] Pursuant to the Secretary's new rule, the Board began refusing to accept jurisdiction on this issue until after the filing of a cost report and issuance of a Notice of Program Reimbursement for the year in question. The hospitals that challenged the validity of HCFAR 84-1 in federal district court were all successful.[88] In five federal appeals, the providers have obtained affirmation in four cases.[89] Only the Eighth Circuit, in *Springdale Memorial Hospital v. Bowen*,[90] has been unwilling to require the Board to accept jurisdiction.

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[82]*See infra* notes 158-70 and accompanying text for an overview of the prospective payment system.

[83]42 U.S.C. § 1395(a) (1982). *See* Pub. L. No. 98-21, § 602, 97 Stat. 65, 163-66 (1983).

[84]42 U.S.C. § 1395oo(a)(1)(A)(ii) (Supp. III 1985). *See supra* note 33 for the complete text.

[85]*See* 42 C.F.R. §§ 412.70 - 412.74 (1986); 42 U.S.C. § 1395ww(d)(1) (Supp. 1985).

[86]In an appendix to one of the cases on this issue, the court indicated that the Board had accepted jurisdiction over 31 appeals prior to the issuance of HCFAR 84-1. Washington Hosp. Center v. Bowen, 795 F.2d 139, 142 (D.C. Cir. 1986).

[87]49 Fed. Reg. 22,413, 22,415 (1984).

[88]*See* Doctors Hosp., Inc. v. Bowen, 811 F.2d 1448, 1452 n.2 (11th Cir. 1987).

[89]*See* Doctors Hosp., Inc. v. Bowen, 811 F.2d 1448 (11th Cir. 1987); Sunshine Health Sys., Inc. v. Bowen, 809 F.2d 1390 (9th Cir. 1987); St. Francis Hosp. v. Bowen, 802 F.2d 697 (4th Cir. 1986); Washington Hosp. Center v. Bowen, 795 F.2d 139 (D.C. Cir. 1986). Largely because it came from the District of Columbia court, the *Washington* case is considered to be the leading decision.

[90]818 F.2d 1377 (1987).

Although the weight of authority favors finding HCFAR 84-1 to be an unlawful exercise of administrative authority, that finding is inconsistent with the plain language of the conforming amendments. In amending section 1395oo, Congress inserted the provision for review of prospective payment questions under subpart (a), rather than creating a separate subpart. Subpart (a) plainly anticipates that Board review is made "with respect to [a] cost report."[91] The Secretary's interpretation is reasonable, and not arbitrary or capricious, as most courts have found.[92] If Congress had expressly intended to exempt prospective payment determinations from the cost report requirement, the amendments could have been incorporated into a separate subpart. Further evidence that Congress did not intend the new review provisions to alter the cost report requirement can be found in Congress' use of the term "conforming amendments." The Supreme Court has implied that when Congress designates an amendment as being "conforming," this is evidence that it should be treated as a non-substantive reaction to related legislation.[93] Therefore, the Eighth Circuit's reasoning in *Springdale* offers the better analysis, based on strict statutory construction.

Yet whatever the merits of the arguments on this issue, HCFAR 84-1 is still a dubious exercise of administrative authority. At best, the ruling merely delayed the inevitable. By requiring providers to wait until the end of the year to file appeals, the Secretary created a situation where the Board was hit by a wave of appeals, rather than a continuous stream. This has the effect of slowing down an already overburdened review system.[94] If future changes in Medicare law require preliminary determinations by the fiscal intermediaries, the dissatisfied provider should look first to the language of any conforming amendments and legislative history for applicable changes in availability of review. If there are no accompanying changes in the jurisdictional provisions, current law favors the availability of administrative review prior to the issuance of the Notice of Program Reimbursement. Moreover, the Administrative Conference, an independent federal agency responsible for finding ways in which other agencies can be improved, has recently recommended to the HHS that the Board's jurisdictional authority be expanded to hear appeals in a more timely fashion.[95]

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[91]42 U.S.C. § 1395oo(a) (Supp. III 1985). *See supra* note 33 for the complete text.

[92]Arbitrary and capricious is the standard used in determining if the actions of an administrative agency are in violation of the Administrative Procedure Act. 5 U.S.C. § 706(a)(A) (Supp. III 1985).

[93]CBS, Inc. v. FCC, 453 U.S. 367, 381-82 (1981).

[94]*See supra* note 57.

[95]Burda, *Ganeles Braces the PRRB for Change*, Hospitals, January 5, 1987, at 44. This recommendation was based on a report submitted to the Administrative Conference

Finally, federal regulations permit the reopening and revision of a decision by the intermediary or the Board any time within three years of the date of notice of the determination.[96] A motion for reopening can be made by either the rendering body or the affected provider, and is permitted if new and material evidence has been submitted, an obvious error has been made, or the previous determination is inconsistent with the law.[97] However, only the authority rendering the decision has jurisdiction to reopen. Thus, a determination by the intermediary not to reopen is not reviewable by the Board.[98]

After obtaining administrative review and being defeated on the merits, the provider must now look to the next available avenue of appeal—the federal courts.

IV. Judicial Review

The Social Security Act prohibits judicial review of any claim arising under Medicare through the usual jurisdictional channel of section 1331, title 28, United States Code: claims involving federal questions.[99] Judicial review is only available where provided in the Act itself.[100] For the Medicare provider, judicial review, like administrative review, is available only through section 1395oo.[101]

Except for certain statutory provisions that have been put beyond the reach of administrative or judicial scrutiny, judicial review of any final determination of the Board, or of any subsequent modification of a Board decision by the Secretary is generally available.[102] Although this grant of authority seems straightforward, just as with administrative review, the courts have been called upon many times to discover the true intent of Congress. Moreover, just as with administrative review, the courts have not always achieved consistent results. The following sections examine the various prerequisites to judicial review in detail.

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by Eleanor Kinney, Assistant Professor of Law and Director of the Center for Law and Health, Indiana University School of Law, Indianapolis. An updated version of that report was recently published: Kinney, *The Medicare Appeals System for Coverage and Payment Disputes: Achieving Fairness in a Time of Constraint*, 1 Adm. L.J. 1 (1987).

[96] 42 C.F.R. § 405.1885(a) (1987).

[97] *Id.*

[98] *Id.* § 405.1885(c).

[99] 42 U.S.C. § 405(h) (1982), made expressly applicable to Medicare by 42 U.S.C. § 1395ii (1982).

[100] *Id.* § 405(g).

[101] 42 U.S.C. § 1395oo(f) (1982 & Supp. III 1985). *See supra* note 33 for the complete text.

[102] *Id.* § 1395oo(f), (g).

A. Timeliness of Request

Civil actions against the Secretary must be commenced within 60 days of notice of a final determination.[103] Unlike the administrative timeliness requirement, however, this rule is considered to be a statute of limitations, rather than a jurisdictional bar.[104] This distinction is critical, in that statutory timeliness is a waivable requirement, whereas subject matter jurisdiction is not.[105] By way of illustration, in a 1984 suit in which the provider was late in filing, the court refused to dismiss the case because the Secretary was considered to have waived the timeliness issue by not raising it as an affirmative defense in his responsive pleading.[106] Courts have uniformly held that the 60 day period commences upon receipt of notice by the provider and not at the time of issuance of the final determination.[107]

B. Venue

A civil action may be brought either in the district court for the district in which the provider is located or in the district court for the District of Columbia.[108] This provision is one of the reasons why the decisions of the District of Columbia Court of Appeals are so influential. If the District of Columbia court adopts a provider-favorable position, an incentive is created for providers to commence their actions there, rather than in their home jurisdiction.

When several providers aggregate their appeals, their "location" for the purpose of venue is considered to be the judicial district in which the greatest number of providers are located.[109]

C. Expedited Judicial Review and the Requirement of Exhaustion of Administrative Remedies

Prior to 1980, a provider challenging the validity of a statute or regulation was required to bring an appeal before the Board, despite the Board's lack of authority to invalidate regulations promulgated by

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[103] *Id.* § 1395oo(f)(1).

[104] *See* Lloyd Nolan Hosp. & Clinic v. Heckler, 762 F.2d 1561 (11th Cir. 1985); Alexandria Hosp. v. Heckler, 586 F. Supp. 581 (E.D. Va. 1984); Bedford County Mem. Hosp. v. Heckler, 583 F. Supp. 367 (W.D. Va. 1984).

[105] Laffey v. Northwest Airlines, Inc., 567 F.2d 429, 474 (D.C. Cir. 1976), *cert. denied*, 434 U.S. 1086 (1978). *See* Fed. R. Civ. P. 12(h)(3).

[106] *Alexandria Hosp.*, 586 F. Supp. 581 (E.D. Va. 1984).

[107] *See* Lloyd Nolan Hosp. & Clinic v. Heckler, 762 F.2d 1561 (11th Cir. 1985); Sun Towers, Inc. v. Heckler, 725 F.2d 315 (5th Cir. 1984).

[108] 42 U.S.C. § 1395oo(f)(1) (Supp. 1985).

[109] *Id.*

the HHS.[110] Only after the Board renders a decision could the provider then bring his action in federal court. This requirement of "exhaustion of administrative remedy" is a cornerstone of judicial review of administrative action, and has been rigidly enforced in the Medicare context.[111] Resourceful providers have sought to circumvent this requirement in a number of ways: through mandamus jurisdiction,[112] through the Administrative Procedure Act,[113] and through assertion that no other avenue of appeal exists.[114] But the courts have consistently stated that resort to the administrative process, despite its prospective futility, was a prerequisite to federal jurisdiction. In 1980, however, Congress attempted to help providers avoid "time consuming and irrelevant administrative review merely to have the right to bring suit" by giving them "the right to immediate judicial review in instances where the Board determines it lacks jurisdiction to grant the relief sought."[115] With these commendable intentions, section 1395oo was amended to provide for expedited judicial review.[116]

Despite the good intentions of Congress, the amendment has done little to make the appeals process more efficient. The statute still requires the provider to have met the jurisdictional requirements of subpart (a) of section 1395oo before the Board renders a determination of whether expedited judicial review is appropriate.[117] Thus, the provider must file a cost report, obtain a determination by the intermediary, file an appeal for expedited review to the Board, and then obtain a ruling on whether the jurisdictional requirements of subpart (a) have been met, prior to the beginning of the 30 day period within which the Board must render a determination on the availability of expedited judicial review.[118] The reality of expedited review is in stark contrast to the words of Congressman Heftel, in explaining the amendment:

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[110]Hospital Ass'n v. Secretary of HHS, 820 F.2d 533, 539 (1st Cir. 1987).

[111]*See, e.g.*, Heckler v. Ringer, 466 U.S. 602, 617 (1984); Daniel Freeman Mem. Hosp. v. Schweiker, 656 F.2d 473 (9th Cir. 1981); Association of Am. Medical Colleges v. Califano, 569 F.2d 101 (D.C. Cir. 1977).

[112]*See, e.g.*, Ohio Hosp. Ass'n v. Heckler, 654 F. Supp. 729 (S.D. Ohio 1986). Mandamus jurisdiction might be available if the matter in controversy was wholly procedural in nature, and the Secretary owed a clear, nondiscretionary duty. Ellis v. Blum, 643 F.2d 68 (2d Cir. 1981).

[113]*See, e.g.*, Chelsea Community Hosp. v. Michigan Blue Cross, 630 F.2d 1131, 1133 (6th Cir. 1980). *See generally* Califano v. Sangers, 430 U.S. 99 (1977).

[114]Good Samaritan Medical Center v. Secretary of HHS, 776 F.2d 594, 597-98 (6th Cir. 1985).

[115]H.R. REP. No. 1167, 96th Cong., 2d Sess. 394 (1980).

[116]42 U.S.C. § 1395oo(f)(1) (Supp. III 1985). *See supra* note 33 for complete text.

[117]42 C.F.R. § 405.1842(b)(2) (1987).

[118]42 U.S.C. § 1395oo(f)(1) (Supp. III 1985).

> Specifically, under current law providers may not seek judicial review of regulations of policies of [the HHS] until after the provider has gone through a long, tortuous process of preparing and filing cost reports; awaiting a decision by the fiscal intermediary; and appealing that decision to the PRRB, which must declare what everybody already knows—that the PRRB has no authority to decide the issues . . . . Our bill would change this situation by allowing the provider to obtain immediate judicial review in such cases—namely, those in which the PRRB has no authority to decide the case.[119]

If Congress is serious about improving the review process, then the law should be amended to allow providers to bypass the Board completely when challenging the validity of a statute or regulation, as long as the provider can show standing to sue.[120] The elimination of the Board from this type of proceeding would have the additional benefit of facilitating the use by providers of the class action suit. The Supreme Court has endorsed the use of certification of nation-wide classes to resolve actions involving administrative challenges.[121] The class action is particularly appropriate in the Medicare context, where the filing of a multiplicity of individual suits has resulted in differing results for similarly situated individuals.[122]

D. *The Mootness Problem*

One of the more complex and potentially consequential jurisdictional problems has arisen out of litigation involving a 1979 rule which substantially reduced Medicare reimbursement for a hospital's medical malpractice insurance costs. Every challenge to the legality of the 1979 rule was successful;[123] however, the HHS continued to litigate on a piecemeal basis until 1986, when the HHS finally conceded that the 1979 rule was invalid.[124] Although a battle was lost, the HHS had not surrendered the war. The Secretary promulgated a new rule that, from the provider

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[119] 126 Cong. Rec. 22218 (1980) (introductory remarks of Rep. Heftel).

[120] Standing, in this context, means that the amount in controversy requirements have been met, 42 U.S.C. § 1395oo(a)(2) (Supp. III 1985), and the provider is suffering from a legal wrong caused by agency action. 5 U.S.C. § 702 (1982).

[121] Califano v. Yamasaki, 442 U.S. 682, 701-703 (1979).

[122] McClure v. Harris, 503 F. Supp. 409, 413 (N.D. Cal. 1980), *rev'd on other grounds sub nom.* Schweiker v. McClure, 456 U.S. 188 (1982).

[123] *See* Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435, 1441 n.7 (11th Cir. 1987).

[124] *See* 51 Fed. Reg. 11,142, 11,149 (April 1, 1986) (to be codified at 42 C.F.R. § 405).

viewpoint, was not much better than the old rule.[125] The new rule, by its own terms, was to be applied retroactively to all "open" cost reports.[126]

By making the 1986 rule retroactive to all providers with open claims, the Secretary was now able to make a new jurisdictional challenge in new federal cases and in those coming up on appeal. The Secretary now has argued that the retroactive nature of the new rule renders any litigation on the old rule moot, thus eliminating federal jurisdiction.[127] The Medicare statutes authorize the Secretary to make retroactive adjustments to provider reimbursement under certain circumstances.[128] Yet the practical consequences of permitting retroactive rule-making in this situation would be that those providers with claims pending in the federal courts would not be entitled to reimbursement according to pre-1979 rules. They must either accept reimbursement under the 1986 rule or challenge the validity of the 1986 rule starting back at the beginning—at the administrative level. The long term consequences of the successful use of this strategy would be to potentially bind providers into a never-ending series of fruitless legal challenges. In finding that the new rule did not render the litigation moot, the Eleventh Circuit Court of Appeals commented:

> [I]f this case is dismissed as moot, we would be creating a class of cases capable of evading judicial review by the very fact that, after years of litigation challenging an administrative regulation, an agency would be able to moot a given lawsuit by promulgating a new regulation. If we were to find this case moot, the hospitals would have to restart on a long and expensive litigation, only to be confronted again with the possibility that the Secretary could moot that litigation.[129]

The district courts that have addressed this issue have reached conflicting results and are likely to continue to do so until the weight of appellate opinion becomes known.[130] Four appellate courts have rendered decisions to date. The Sixth and Eleventh Circuits have taken a provider-favorable position and have either expressly or implicitly assumed a

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[125]*See* Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435, 1441 n.19 (11th Cir. 1987).

[126]51 Fed. Reg. 11,142, 11,149 (April 1, 1986) (to be codified at 42 C.F.R. § 405).

[127]Mootness is jurisdictional. *See* Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435, 1448 n.22 (11th Cir. 1987).

[128]42 U.S.C. § 1395x(v)(1)(A)(ii) (Supp. III 1985); *see also* Tennessee v. Califano, 631 F.2d 89 (6th Cir. 1980).

[129]*Tallahassee*, 815 F.2d at 1451.

[130]*See id.* at 1448 n.24.

limited degree of jurisdiction.[131] Although both courts denied the Secretary's authority to promulgate retroactive regulations that would have the effect of mooting a present controversy, the courts invalidated only the retroactive aspect of the new rule, expressly finding themselves without jurisdiction to review the prospective validity of the rule.[132] The First Circuit reached a different conclusion. That court also rejected the mootness argument, but found that the federal courts have the jurisdiction to review both the retroactive and the prospective aspects of the new rule.[133] The case was then remanded to the district court for a determination on both questions.[134] In the Seventh Circuit, however, the Secretary was able to gain a victory through an alternative argument.[135] The court refused to address the retroactivity question, instead finding that it was without jurisdiction to hear the appeal because the challenge to the retroactive application of the new rule amounts to an attack on the regulation itself.[136] Thus, the court found itself without jurisdiction until there has been a final determination of the Board with regard to the new regulation. The court reversed the district court's decision ordering reimbursement under the pre-1979 rule and remanded with instructions that the Secretary process the claims using the new regulation.[137] This "final determination" requirement will be examined in more detail in the following section.

The three appellate courts that rejected the Secretary's claims of mootness were obviously concerned about the public policy aspects of allowing an agency the unfettered ability to thwart the purposes of judicial review. However, the providers had some law to support their position as well. A supporting case for the providers is a 1984 Supreme Court ruling in which the Court held that when a party to a dispute has a monetary interest in the outcome of a litigation, the case cannot be dismissed as moot because of events subsequent to the action.[138] In *Tallahassee Memorial Regional Medical Center v. Bowen*,[139] the Eleventh Circuit, in a detailed and thorough analysis of the mootness question, applied the two-prong test for mootness adopted by the Supreme Court

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[131]*See* Mason General Hosp. v. Secretary of HHS, 809 F.2d 1220 (6th Cir. 1987) (mootness denied implicitly without discussion); Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435 (mootness expressly denied).

[132]*Mason*, 809 F.2d at 1231; *see also Tallahassee*, 815 F.2d at 1456-57.

[133]Hospital Ass'n v. Secretary of HHS, 820 F.2d 533, 539 (1st Cir. 1987).

[134]*Id.*

[135]Appleton Mem. Hosp. v. Bowen, 814 F.2d 408 (7th Cir. 1987).

[136]*Id.* at 410.

[137]*Id.*

[138]Ellis v. Brotherhood of Ry. Clerks, 466 U.S. 435 (1984), *cited in* Hospital Ass'n v. Secretary of HHS, 820 F.2d 533, 537 (1st Cir. 1987).

[139]815 F.2d 1435 (11th Cir. 1987).

in *County of Los Angeles v. Davis*.[140] Under that standard, a case may be dismissed as moot only when the parties lack a legally cognizable interest in the outcome. Jurisdiction, once obtained, can abate only if two conditions have been met. First, there must be no reasonable expectation that the alleged violation will recur. Second, subsequent events must have "completely and irrevocably eradicated the effects of the alleged violation."[141]

Although the weight of authority, and public policy mitigate against the success of the mootness argument, the Secretary will continue to confront providers still litigating the 1979 malpractice rule with this allegation. All this seemingly endless litigation over one rule could have been avoided had the HHS corrected the problems with the 1979 rule when it first became apparent that the rule was hopelessly invalid. The HHS policy of non-acquiescence in judicial rulings has been recently criticized in a report presented to the Administrative Conference of the United States:

> Since the inception of the Medicare program, HHS has taken a very tough stance in provider challenges to payment levels under Part A. As guardian of the Medicare trust funds, and especially considering current budget pressures, this position is clearly appropriate.
>
> At some point, however, a question of fairness is raised. This point may have been reached with respect to some Medicare payment issues in view of the fact that federal district and appellate courts have almost uniformly rejected these policies.
>
> . . . HHS should develop a principled policy on when it will acquiesce to judicial decisions affecting the Medicare program and all other programs under the Social Security Act.[142]

Given the amount of money at stake, the non-acquiescence problem is likely to remain, unless the statutory provisions can be amended to facilitate the use of binding class action litigation.

E. Final Determination

Section 1395oo(f)(1) states: "Providers shall have the right to obtain judicial review of any final decision of the Board, or any reversal, affirmance, or modification by the Secretary."[143] With the statutory

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[140] 440 U.S. 625 (1979).

[141] *Id.*

[142] Kinney, *supra* note 5 at 98-99.

[143] 42 U.S.C. § 1395oo(f)(1) (Supp. III 1985). *See supra* note 34 for the complete text.

exception provided for expedited judicial review, the courts have been fairly uniform in requiring that all claims first have been submitted to the Board for a final decision prior to any judicial review.[144] This section will explore the various forms that a final determination has taken.

1. The Effect of Retroactive Rule-making.—Retroactive rule-making in the context of medical malpractice insurance costs discussed in the preceding section has provided one of the few controversies regarding the final determination requirement.[145] Along with the allegation of mootness, the Secretary has also argued in these cases that until the 1986 rule has actually been applied, and administrative review obtained, there has been no final determination of the Board, and therefore federal jurisdiction cannot exist.[146] This argument has proved problematic for providers. As mentioned in the preceding section, the Seventh Circuit Court of Appeals accepted this reasoning,[147] as has at least one district court.[148] Two other appellate courts faced with this argument found that the lack of final decision only precluded judicial review of the prospective, and not the retroactive application of the new rule.[149] The First Circuit Court of Appeals has been the only court willing to find federal jurisdiction to review both the prospective and retroactive aspects of the rule.[150] That court's reasoning—that the new rule simply raises another question of law "relevant to the matters in controversy" pursuant to the jurisdictional grant of section 1395oo(f)(1)—is persuasive.[151] And the same policy arguments raised by the mootness problem are applicable here. Moreover, as the court pointed out, although the prospective futility of administrative remand is not a factor to be considered if the jurisdictional requirements have not been met, "it is a proper consideration . . . when those jurisdictional requirements have been met."[152] In other words, once a court has properly assumed jurisdiction, subsequent events should not then demand an administrative remand. This is the proper interpretation of section 1395oo.

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[144]*See, e.g.*, Mercy Hosp. of Laredo v. Heckler, 777 F.2d 1038 (5th Cir. 1985); Homewood Professional Care Center, Ltd. v. Heckler, 764 F.2d 1242 (7th Cir. 1985); Association of Am. Medical Colleges v. Califano, 569 F.2d 101 (D.C. Cir. 1977).

[145]*See supra* notes 123-37 and accompanying text.

[146]*See* Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435, 1449 n.27 (11th Cir. 1987); Hospital Ass'n v. Secretary of HHS, 820 F.2d 533, 537 (1st Cir. 1987).

[147]Appleton Mem. Hosp. v. Bowen, 814 F.2d 408 (7th Cir. 1987).

[148]St. Louis Univ. Medical Center v. Bowen, 655 F. Supp. 72 (E.D. Mo. 1986).

[149]Mason General Hosp. v. Secretary of HHS, 809 F.2d 1220, 1231 (6th Cir. 1987); *see also Tallahassee*, 815 F.2d at 1456-57.

[150]Hospital Ass'n v. Secretary of HHS, 820 F.2d 533 (1st Cir. 1987).

[151]*Id.* at 538 (citing 42 U.S.C. § 1395oo(f)(1) (Supp. III 1985); 5 U.S.C. § 706 (1982)).

[152]*Id.* at 539.

2. Board Denial of Jurisdiction.—Courts agree that a decision by the Board not to exercise jurisdiction is a final decision for the purpose of judicial review.[153] If the Board declines jurisdiction for failure to meet one of the threshold requirements of administrative review, that decision is subject to judicial review. If it were not, the Board could preclude any judicial review by simply denying jurisdiction to any claim viewed as non-meritorious.[154]

3. Preclusion of Availability to HHS.—Interestingly, section 1395oo authorizes only a provider to seek judicial review of a Board decision.[155] However, there seems to be little practical consequence to this omission. The Secretary has the authority to affirm, modify, or reverse any decision of the Board, thus obviating the need for the Secretary to seek judicial review under section 1395oo.[156] Furthermore, if a district court reverses a Board decision in favor of the provider, the Secretary may now seek appellate review, because section 1291, title 28 of the Code governs the availability of appellate review.[157]

V. Medicare Provisions Not Subject to Review

Congress has made certain aspects of provider reimbursement under Medicare not available to any form of administrative or judicial review. An intermediary determination that an expense item is one of those listed in section 1395y, title 42, is not subject to review.[158] This section of the Code lists certain specific expenses that are excluded from Medicare coverage. More importantly, the major provisions of inpatient reimbursement under the prospective payment system adopted in 1983 and completely phased in by 1987 are excluded from any form of review.[159] To understand the significance of this exclusion, some background information on the prospective payment system is necessary.

In an effort to purchase health care services for the aged more efficiently, Congress in 1983 adopted provisions which made major changes in the way hospitals are reimbursed for providing inpatient

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[153]*See* Saline Community Hosp. Ass'n v. Secretary of HHS, 744 F.2d 517 (6th Cir. 1984); Athens Community Hosp., Inc. v. Schweiker, 686 F.2d 989, 994 (D.C. Cir. 1982), *modified on other grounds*, 743 F.2d 1 (D.C. Cir. 1984).

[154]Cleveland Mem. Hosp. v. Califano, 444 F. Supp. 125, 128 (E.D.N.C. 1978), *aff'd*, 594 F.2d 993 (4th Cir. 1979).

[155]42 U.S.C. § 1395oo(f)(1) (Supp. III 1985). *See supra* note 34 for complete text.

[156]*Id.*

[157]28 U.S.C. § 1291 (1982); *see also* Daviess County Hosp. v. Bowen, 811 F.2d 338, 342 (7th Cir. 1987).

[158]42 U.S.C. § 1395oo(g)(1) (Supp. III 1985).

[159]*Id.* § 1395oo(g)(2).

care.[160] Prior to 1983, hospitals were reimbursed for their costs incurred in the treatment of Medicare patients.[161] After 1983, hospitals began being reimbursed at predetermined fixed rates which vary according to the type of services rendered.[162] Approximately 470 categories were created, called Diagnosis Related Groups [DRGs].[163] Thus, a hospital which treats a patient that is classified in a DRG that entitles the hospital to $7,000 reimbursement will receive that amount, regardless of whether the costs incurred were actually less or substantially greater. Although a complete discussion of the impact of this system is beyond the scope of this Note, it is worth noting that prospective reimbursement creates an enormous change in the financial incentives of inpatient care, and substantially diminishes the significance of the cost report in determining provider reimbursement.[164]

At the same time these major amendments were being adopted, Congress amended the jurisdictional provisions of section 1395oo.[165] Neither administrative nor judicial review is available to resolve controversies involving the establishment of DRGs,[166] the methodology used in classifying patients into DRG groups,[167] or the weighting factors attached to each DRG which is used to calculate reimbursement.[168] Nor is review available for disputes involving budget neutral adjustments to the prospective payment rates.[169] Thus, the regulations governing the largest source of hospital Medicare revenue, inpatient services, have been specifically withheld from the overview of a neutral judiciary.[170]

VI. Future Jurisdictional Litigation

The significance of the cost report and, by implication, the need for administrative and judicial review, was greatly diminished by the advent of prospective reimbursement for inpatients. However, medical

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[160]*See* H.R. Rep. No. 25, 98th Cong., 1st Sess. 132 (1983) (discussing the reasoning for adopting prospective reimbursement as codified in 42 U.S.C. § 1395ww(d) (Supp. III 1985)).

[161]42 U.S.C. § 1395x(v)(1)(A) (1982).

[162]42 U.S.C. § 1395ww(d) (Supp. III 1985).

[163]*Id.*; *see also* 49 Fed. Reg. 34,728, 34,780-90 (1984).

[164]*But see supra* note 26 and accompanying text.

[165]42 U.S.C. § 1395oo(g)(2) (Supp. III 1985).

[166]42 C.F.R. § 405.1804(b)(1) (1986).

[167]*Id.* at § 405.1804(b)(2).

[168]*Id.* at § 405.1804(b)(3).

[169]*Id.* at § 405.1804(a).

[170]Congress created the Prospective Payment Assessment Commission to determine the various factors used to determine the reimbursement factors for each DRG. These factors are updated yearly and published in the Federal Register. 42 U.S.C. §§ 1395ww(d)(4)(D), (e)(2)-(3) (Supp. III 1985).

education expenses, outpatient service costs, capital expenditures, and loss attributable to bad debt are all still significant reimbursements determined by the cost report.[171] Not coincidentally, reimbursement methods for all these items have been targeted for change by the HHS or Congress.[172]

In all likelihood, these changes will be opposed by health care providers. While the specific case holdings discussed in the preceding sections will be relied upon extensively, the general doctrines from which much of the case law has developed will be of value. The following sections touch briefly on the major themes which emerge from an assimilation of case law interpreting the jurisdictional parameters of Medicare provider initiated litigation. The doctrines discussed were selected not only for their recurrence in the case law, but because of their general applicability to a variety of jurisdictional issues.

A. *Judicial Deference*

The most frequently occurring theme in provider reimbursement disputes is that of "judicial deference." This doctrine requires courts to defer to the agency's interpretation of a statute the agency is charged with administering.[173] In other words, this doctrine creates a presumption in cases involving statutory interpretation that the Secretary's interpretation is to be given substantial deference by the courts. However, the "judicial deference" doctrine has limitations in its application. The Supreme Court has taken the position that deference is only appropriate where the statute is ambiguous or silent on a particular issue.[174] Of course, the courts do not always agree as to whether a statute is ambiguous.[175] Further, courts will not defer to an agency interpretation when the interpretation cannot be reconciled with congressional intent.[176] In this respect, the statutory interpretation urged by the Secretary has

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[171]*See supra* note 26.

[172]*See* 51 Fed. Reg. 6755 (February 26, 1986) (Proposed rule on changes to medical education payment); 52 Fed. Reg. 20,623 (June 2, 1987) (Proposed rule on changes in outpatient payment); 52 Fed. Reg. 18,840 (May 19, 1987) (Proposed rule on capital payments); *Currents*, HOSPITALS, August 5, 1987, at 26 (HCFA circulation of a proposal draft that would halt Medicare payments for bad debt).

[173]Blum v. Bacon, 457 U.S. 132, 141 (1982).

[174]Chevron U.S.A. v. Natural Res. Defense Council, 467 U.S. 837, 842-43 (1984).

[175]In their respective interpretations of section 1395oo(f), compare St. Luke's Hosp. v. Secretary of HHS, 810 F.2d 325, 331 (1st Cir. 1987) ("[W]e interpret the language literally, and we find no initial ambiguity.") with Athens Community Hosp. v. Schweiker, 743 F.2d 1, 8 (D.C. Cir. 1984) ("[T]he statute is unclear (to put it mildly in the context of this case) . . . .").

[176]Securities Industry Ass'n v. Board of Governors, 468 U.S. 137, 143 (1984).

often been found to be at odds with the plain language of the statute.[177] Providers have also argued that the weight to be given the agency interpretation will depend on the consistency of the agency's position with prior actions.[178] Hospitals have thus been able to take advantage of prior inconsistencies in the Board's actions.[179]

Moreover, the Supreme Court has recently explained that the "judicial deference" rule is applicable only where the agency is applying an agreed upon legal standard to a set of facts, and not where there is a question of interpretation of a contested legal standard.[180] Thus, it would appear that courts need not show deference when the matter is one of pure statutory construction.[181] Similarly, providers have successfully argued that while HHS may have special expertise in administering the substantive provisions of Medicare, it has no special expertise in interpreting jurisdictional statutes, and thus deference is not necessarily required when the contested issue involves jurisdiction.[182]

B. Congressional Intent

Another critical aspect of provider jurisdictional disputes has been the relationship of the action to congressional intent, as discerned through the legislative history of section 1395oo. Congress has been careful to amend the statute when necessary, and the legislative history, though brief, has been frequently invoked. Congressional intent has proved to be dispositive of provider disputes, both for and against the providers.[183] A review of the legislative history indicates a trend toward broadening the jurisdictional borders of provider disputes, at least until 1983. The original statute, which only permitted judicial review where the Secretary reversed or modified a Board decision, was modified in 1974 to permit

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[177]*See, e.g.*, Doctor's Hosp., Inc. v. Bowen, 811 F.2d 1448, 1452 (11th Cir. 1987); Hospital Ass'n v. Secretary of HHS, 820 F.2d 533, 537-38 (1st Cir. 1987).

[178]INS v. Cardoza-Fonseca, 107 S. Ct. 1207, 1221 n.30 (1987). *Accord* Bowen v. American Hosp. Ass'n, 106 S. Ct. 2101, 2122 n.34 (1986).

[179]St. Luke's Hosp. v. Secretary of HHS, 810 F.2d 325 (1st Cir. 1987).

[180]107 S. Ct. at 1221.

[181]*Id.*

[182]Adams House Health Care v. Heckler, 817 F.2d 587, 594 (9th Cir. 1987); St. Luke's Hosp. v. Secretary of HHS, 810 F.2d 325 (1st Cir. 1987).

[183]*See* Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435, 1463 (11th Cir. 1987) (In ruling for the provider, the court noted, "The clear language of the statute and the legislative history of the PRRB lead us to conclude. . ."); Springdale Mem. Hosp. Ass'n v. Bowen, 818 F.2d 1377, 1386 (8th Cir. 1987) (In ruling for the HHS, the court noted, "Nothing in the legislative history indicates that Congress intended this conforming amendment to [eliminate the NPR] . . . . This, coupled with our reading of section 1395oo(a) leads us to conclude. . . .").

review of a decision of the Board.[184] Then, in 1980, the statute was again amended to provide for expedited judicial review.[185] Sharp limitations on review were then adopted as part of prospective reimbursement in 1983.[186] How subsequent legislative history will affect provider claims will largely depend on the nature of the dispute. While Congress seems willing to provide for more access to review of minor matters, the new trend with regard to the major provisions of payment methodologies is toward precluding review.

C. *The* Michigan Academy *Case*

Congress and courts have spoken often of a strong presumption of the availability of judicial review.[187] The Supreme Court has underscored this presumption in the Medicare context in the recent case of *Bowen v. Michigan Academy of Family Physicians.*[188] In this case, a group of physicians challenged the method by which certain payments were made under Medicare Part B.[189] Although prior case law tended to indicate that judicial review was not available for Part B payment determinations, the Court held that review is only foreclosed from determinations of benefit amounts, and not from the method by which the determinations are made.[190] Providers have been quick to incorporate this theme into their arguments. Some courts have found the *Michigan Academy* holding supportive of the provider viewpoint,[191] but others have not.[192] The implication of *Michigan Academy*—that the methods by which Medicare payments are made should be available to judicial review—does not square with the 1983 amendments foreclosing review of payment methodologies affecting health care providers. As yet, no challenge has been made to the jurisdictional limitations of the 1983 amendments. It has been argued that the lack of challenge to the statute may be attributable to the fact that hospitals have been doing reasonably well financially under prospective payment, and that it would be difficult to show that the methodology is arbitrary or capricious.[193] At some point, however,

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[184]42 U.S.C. § 1395oo(f)(1) (Supp. 1985). Pub. L. No. 93-484, 88 Stat. 1459 (1974).

[185]*See supra* text accompanying note 115.

[186]*See supra* text accompanying notes 165-70.

[187]*See, e.g.*, Abbott Laboratories v. Gardner, 387 U.S. 136, 140 (1987) (citing cases); S. Rep. No. 752, 79th Cong., 1st Sess. 26 (1945).

[188]476 U.S. 667 (1986).

[189]*Id.* at 668.

[190]*Id.* at 678.

[191]Tallahassee Mem. Regional Medical Center v. Bowen, 815 F.2d 1435, 1463-64 n.54 (11th Cir. 1987).

[192]Bethesda Hosp. v. Secretary of HHS, 810 F.2d 558, 561 (6th Cir. 1987).

[193]Kinney, *supra* note 5 at 88.

financial incentives will force a provider group to challenge the preclusion of review, and when that happens, the providers will rely heavily on the *Michigan Academy* holding.

VII. Conclusion

The burdensome backlog of pending appeals to the Board[194] and the voluminous number of court decisions[195] are evidence that the health care providers are willing to litigate when the Secretary or Congress makes decisions affecting their interests. Providers are frustrated, however, by the HHS policy of non-acquiescence.[196] Furthermore, despite the pronouncements of the Supreme Court favoring the class action in the administrative context, the rigid timing requirements of administrative and judicial review make it virtually impossible for providers to get certification to mount class action challenges to offensive regulations.[197] The piecemeal litigation of the same issues, and the conflicting results that are frequently obtained, have made the resolution of provider disputes a highly technical, time-consuming, and expensive process. By insulating certain aspects of the Medicare program from judicial scrutiny,[198] Congress has foreclosed any possibility of recourse for health care providers who believe that the provisions are unfair or otherwise invalid.

These are volatile times for the health care industry. Prospective reimbursement and other regulatory changes are a response to what has been perceived as a runaway escalation of health care costs.[199] As Congress and the HHS look for new ways to limit Medicare expenditures, any

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[194]*See supra* note 57.

[195]*See supra* note 6.

[196]*See supra* note 142 and accompanying text.

[197]In order to obtain class certification, Fed. R. Civ. P. 23 requires, *inter alia*, numerosity of class, common questions of law or fact, and that the representative parties typify and be able to adequately protect the interests of the entire class. If the problems of coordinating the appeals process among hundreds of hospitals all in the different jurisdictions, and all winding their way through the administrative appeal process at varying speeds could be overcome statutorily, the next task would be to determine to what extent certification would extend to other similarly situated providers. In making this decision, the courts must weigh the costs and burdens of unsettling previously decided claims against the potential injustice of not doing so. McClure v. Harris, 503 F. Supp. 409, 413 (N.D. Cal. 1980), *rev'd on other grounds sub nom.* Schweiker v. McClure, 456 U.S. 188 (1982).

[198]*See supra* notes 158-70 and accompanying text.

[199]*See, e.g.*, Schramm, *State Hospital Cost Containment: An Analysis of Legislative Initiatives*, 19 Ind. L. Rev. 919, 920 (1986); Kinney, *Making Hard Choices Under the Medicare Prospective Payment System: One Administrative Model for Allocating Medical Resources Under a Government Health Insurance Program*, 19 Ind. L. Rev. 1151, 1151 (1986).

gains made will probably come at the expense of the health care providers rather than the health care beneficiaries. In light of these inevitable changes, the time has come for a more expansive interpretation of the jurisdictional parameters that govern Medicare provider reimbursement disputes, or perhaps even legislative reform. In *Michigan Academy*, the Supreme Court spoke of a strong presumption of administrative and judicial review in the Medicare context.[200] That viewpoint has been underscored by the more recent *Bethesda Hospital*[201] case as well. Since Congress has sharply restricted significant aspects of Medicare reimbursement from judicial oversight,[202] it has become even more imperative that the Board and the federal judiciary interpret the jurisdictional statutes broadly in disputes over the provisions still subject to review. What is needed is statutory constructions that will allow Medicare providers the widest access to review of the regulatory changes that affect both their ability to function in the health care marketplace and the delivery of health care services.

Douglas E. Cressler

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[200]*See supra* note 187 and accompanying text.
[201]*See supra* notes 69-80 and accompanying text.
[202]*See supra* notes 158-70 and accompanying text.

The Superfund Insurance Dilemma: Defining the Super Risks and Rights of Comprehensive General Liability Policies

I. Introduction

The court room confrontations over who will pay for "cleaning up" America's past sins of hazardous waste disposal have moved to a new arena and formidable combatants have joined the fray. Throughout the United States, insurance companies and their commercial business insureds are engaged in heated litigation to answer that multibillion dollar question. The issue is the extent of the insurers' obligation to defend and indemnify under standard comprehensive general liability (CGL) policies for their insureds' potential or actual liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),[1] commonly known as "Superfund."[2]

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[1]42 U.S.C. §§ 9601-9675 (1982 & Supp. IV 1986). The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), Pub. L. No. 96-510, 94 Stat. 2767 (1980), was enacted in 1980. CERCLA was amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA), Pub. L. No. 99-499, 101 Stat. 1613 (1986). SARA established new cleanup standards, settlement and enforcement provisions as well as increased the Fund available to the federal government to initiate response actions. However, the pre-SARA provisions of CERCLA relevant to insurance coverage issues are essentially unchanged. Where SARA has significantly modified insurance related provisions of the 1980 Act, those provisions will be highlighted.

Since its inception, CERCLA and its program implementation have been the subjects of intense comment, criticism and legal analysis. The Act has been described by one jurist as "a hastily drawn piece of compromise legislation, marred by vague terminology and deleted provisions. . . . [N]umerous important features were deleted during the closing hours of the Congressional session. . . . The courts are once again placed in the undesirable and onerous position of construing inadequately drawn legislation." United States v. Northeastern Pharmaceutical and Chem. Co., 579 F. Supp. 823, 838 n.15 (W.D. Mo. 1984). For a general guide to commentaries on a wide range of CERCLA related legal issues, see Note, *CERCLA 1980-1985: A Research Guide*, 13 Ecology L.Q. 311 (1986). *See also Developments in the Law—Toxic Waste Litigation*, 99 Harv. L. Rev. 1458 (1986); BNA Special Report, *Superfund: Litigation and Cleanup*, 16 Env't Rep. (BNA) No. 9 (June 28, 1985) [hereinafter *Superfund I*]. For a comprehensive analysis of SARA, see Atkeson, Goldberg, Ellrod & Connors, *An Annotated Legislative History of the Superfund Amendments and Reauthorization Act of 1986 (SARA)*, 16 Envtl. L. Rep. (Envtl. L. Inst.) 10360 (1986) [hereinafter *SARA History*] and BNA Special Report, *Superfund II: A New Mandate*, 17 Env't. Rep. (BNA) No. 42 (February 13, 1987) [hereinafter *Superfund II*].

[2]All references herein to Superfund are to the Comprehensive Environmental Response, Compensation, and Liability Act, as amended by the Superfund Amendments and Reauthorization Act of 1986, 42 U.S.C. §§ 9601-9675.

Superfund authorizes the federal[3] government to initiate or compel others to undertake removal and remedial[4] actions to cleanup hazardous waste sites where there is a release or a threatened release of a hazardous substance into the environment.[5] The Act also permits the federal and appropriate state government to recover the cost of natural resource damages[6] and allows private parties to bring their own cost recovery

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[3]The President delegated authority to the United States Environmental Protection Agency (USEPA) to serve as the principal federal agency in Superfund activities in Executive Order 12,316, 46 Fed. Reg. 42,237 (1981).

Pre-SARA participation by the state governments in federal cleanup activities was very limited; yet, the Act required the states to pay 10% of the cost of cleaning up private sites within their jurisdiction. Under SARA, the states will continue to cost share 10% of the cleanup costs, but their role in setting standards, enforcement and settlement negotiations has greatly expanded. *SARA History*, *supra* note 1, at 10379-83.

Nearly forty states have enacted their own "mini-Superfund" statutes patterned after the federal legislation. However, the majority of states with "mini-Superfund" programs have reported that they have neither the level of funds nor staff to keep pace with the number of confirmed sites not eligible for federal funding. Association of State and Territorial Solid Waste Management Officials (ASTSWMO) Survey of State Hazardous Waste Programs, *cited in Taking Up the Slack: Mini-Superfunds in the States*, 13 EPA Journal 9, 32 (January/February 1987) [hereinafter EPA Journal].

[4]CERCLA § 101(23) and (24), as amended, 42 U.S.C. § 9601, define the terms "remove" or "removal" and "remedy" or "remedial action," respectively. The principal difference between the terms is "removal" refers to short term actions while "remedial actions" are actions consistent with a permanent remedy which may be taken instead of or in addition to removal actions. In SARA, the Congress expressed a strong preference for permanent treatment. SARA § 121(a), CERCLA § 121(b)(1), as amended. This imprecise "preference" for more expensive permanent solutions along with more stringent performance standards are controversial aspects of SARA. As one high USEPA official stated, " 'There's probably not enough money in the world to clean up all the sites permanently.' " *Superfund II*, *supra* note 1, at 42.

[5]CERCLA § 101(22), as amended, 42 U.S.C. § 9601, defines the term release as "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping or disposing into the environment . . . ." Most courts have not had to decide whether a release or threatened release has occurred. In an early Superfund case, one court did observe that the act of disposal, without more, does not necessarily create CERCLA liability. United States v. Wade, 577 F. Supp. 1326, 1334 n.6 (E.D. Pa. 1983).

CERCLA § 101(14), as amended, 42 U.S.C. § 9601, also broadly defines the term "hazardous substance" and incorporates by reference, substances listed as hazardous under other environmental statutes. There is little dispute that the government need only show that the waste contains an unspecified quantity of a hazardous substance as defined in the Act to establish liability. *See, e.g.*, *Wade*, 577 F. Supp. at 1332-33.

[6]CERCLA § 107(a)(4)(C), as amended, 42 U.S.C. § 9607(a)(4)(C). The federal government has been slow in promulgating final guidelines for the assessment of natural resource damages. It was not until six years after the original passage of CERCLA that the guidelines were published. 51 Fed. Reg. 27,674 (Aug. 1, 1986). This delay may well explain why the government has not made many claims under this provision. *Superfund II*, *supra* note 1, at 35.

actions.[7] Potentially responsible parties who may be found jointly and severally liable under CERCLA to undertake cleanup actions or reimburse for cleanup costs incurred by others,[8] include past and present owners and operators of the hazardous waste sites as well as generators, sellers and transporters[9] of the wastes disposed of or treated at a facility.[10]

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[7]CERCLA § 111(a)(2), as amended, 42 U.S.C. § 9611, authorizes the use of Superfund monies to reimburse private parties for costs they incur in cleaning up sites, if those costs are approved and certified by the federal government. Private parties may instead sue responsible parties directly for their cleanup costs under CERCLA § 107(a)(4), as amended, 42 U.S.C. § 9607(a)(4).

[8]As originally enacted, CERCLA did not mandate that liability be joint and several. However, most courts which have addressed the issue have determined that imposition of strict, joint and several liability is appropriate where the harm is indivisible. United States v. Northeastern Pharmaceutical & Chem. Co., 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 108 S. Ct. 146 (1987); United States v. Ottati & Goss, Inc., 630 F. Supp. 1361 (D.N.H. 1985); United States v. Chem-Dyne Corp., 572 F. Supp. 802 (S.D. Ohio 1983). In SARA, Congress apparently affirmed the courts imposition of strict, joint and several liability as it did not change the liability provisions.

[9]CERCLA § 107(a), as amended, 42 U.S.C. § 9607(a), identifies four classes of persons from whom response costs may be recovered:

> (1) the owner and operator of a vessel or a facility,
> (2) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of,
> (3) any person who by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances, and
> (4) any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance, shall be liable for-
>> (A) all costs of removal or remedial action incurred by the United States Government or a State or an Indian tribe not inconsistent with the national contingency plan;
>> (B) any other necessary costs of response incurred by any other person consistent with the national contingency plan
>> (C) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such a release; and
>> (D) the costs of any health assessment or health effects study carried out under section 9604(i) of this title. [This last provision was added by SARA].

Corporate officers and employees may also be found individually liable under CERCLA. In *NEPACCO*, the Eighth Circuit imposed such liability finding that the Act imposes strict liability upon "any person" and is not limited to the defendant corporation. In its

The significance and magnitude of Superfund liability has not been overlooked by the insurance industry or their insureds.[11] Over 27,000 potentially dangerous hazardous waste sites have been identified, and the list continues to grow.[12] However, only those sites which pose the most serious threat to health and the environment, anywhere from 2,500 to 10,000 national priority sites, are eligible for clean-up under Superfund.[13] The cost of cleaning up just the priority sites ranges from over $22 billion to possibly as high as $100 billion, and does not include litigation expenses or the costs associated with analogous state statutes.[14]

Faced with potential liability which may exceed $30 million per site,[15] both insurers and their insureds are turning to the courts to determine their respective rights and obligations under their standard third party liability insurance contracts.[16] The heart of the Superfund insurance coverage controversy is the interpretation of two deceptively simple clauses in CGL policies issued in the late 1960's through the early 1980's.[17] These provisions obligate the insurer to pay on behalf of the insured all sums which the insured shall become legally obligated

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view, any other construction of the Act "would open an enormous, and clearly unintended, loophole in the statutory scheme." *NEPACCO*, 810 F.2d at 743 (the "EPA" suit).

[10]CERCLA § 101(9), as amended, 42 U.S.C. 9601, broadly defines "facility." Courts have interpreted the term to include any site or area where hazardous substances are located. New York v. General Elec. Co., 592 F. Supp. 291, 296 (N.D.N.Y. 1984); United States v. Conservation Chem. Co., 619 F. Supp. 162, 184-85 (D.C. Mo. 1985).

[11]An insurance executive, speaking at a national conference on Corporate Liability, observed that the retroactive, strict liability of CERCLA and other statutes has been a major reason for the elimination of environmental liability insurance. Another problem cited was that the competent company, one that complies with all requirements, may end up paying a greater premium because the diligent handler who keeps good records and tracks where the waste has gone may be a possible "liability target" under the present system of joint and several liability. Dennis R. Connolly, Vice President of Johnson & Higgins, *quoted in Current Developments*, 17 Env't Rep. (BNA) 791 (Sept. 26, 1986).

[12]EPA Journal, *supra* note 3, at 16.

[13]Federal Superfund monies can only be used for sites on the National Priority List. The National Priority List (NPL), authorized by CERCLA § 105(8)(B), as amended, 42 U.S.C. § 9605(8)(B), identifies the worst abandoned or uncontrolled hazardous waste sites targeted for remedial action and is required to be updated annually. As of January 1987, there were 951 sites on the list, but USEPA estimates the NPL may eventually exceed 2500. EPA Journal, *supra* note 3, at 16. The Congressional Office of Technology Assessment estimated the NPL would reach 10,000. Superfund Strategy, OTA-ITE-252, Office of Technology Assessment (April 1985) *reprinted in* Chem. & Radiation Waste Lit. Rep. (Andrews Pub.) 752, 761 (1985) [hereinafter Congressional Assessment].

[14]EPA Journal, *supra* note 3, at 16. Congressional Assessment, *supra* note 13, at 761. *See also supra* note 3 discussion of state programs.

[15]Current Developments, 17 Env't Rep. (BNA) 779 (Sept. 26, 1986).

[16]*See infra* notes 33-34 and accompanying text.

[17]*See infra* notes 40-46 and accompanying text.

to pay as damages because of property damage which occurs during the policy period;[18] and to defend any suit against the insured alleging such damage even if such suit is groundless, false or fraudulent.[19]

The simplicity of these phrases rapidly disappears when the courts are forced to apply them to Superfund fact situations involving a number of complex definitional issues as well as competing public policies. Among the more vigorously contested and debated coverage issues are: whether the pollution was "expected and intended" by the insured;[20] whether "pollution exclusion" clauses apply to past hazardous waste disposal practices;[21] whether there was an "occurrence" within the meaning of the CGL policies;[22] and whether the exclusion for

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[18]Standard Liability Policy Forms of 1966 and 1973 *reprinted in* R. CUSHMAN & C. STAMM, HANDLING PROPERTY AND CASUALTY CLAIMS 458-475 (1985).

The standard policies include similar provisions for "bodily injury." *Id.* Whether standard CGL policies provide coverage for third party claims against the insureds for "bodily injury" because of environmental contamination is another widely litigated issue. However, this issue and the issues discussed *infra* notes 20-23 are beyond the scope of this Note.

[19]*Id.*

[20]The 1973 standard CGL form defines "occurrence" as "an accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage *neither expected nor intended from the standpoint of the insured.*" *Id.* at 470 (emphasis added). Courts have generally focused on whether the insured had an actual intent to cause a harmful result, not whether the acts which gave rise to the damage were intentional. The term "expected" has generally required a finding that the insured knew or should have known "that certain consequences w[ould] result from its actions." City of Carter Lake v. Aetna Casualty & Surety Co., 604 F.2d 1052, 1058-59 (8th Cir. 1979). For cases discussing the "expected or intended" issue, see Annotation, *Construction and Application of Provision of Liability Insurance Policy Expressly Excluding Injuries Intended or Expected by Insured*, 31 A.L.R. 4TH 957 (1984).

[21]The pollution exclusion was incorporated into the 1973 Standard Policy Form:

> The insurance does not apply to bodily injury or property damage arising out of the discharge, dispersal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into or upon the land, the atmosphere, or any water course or body of water, *but this exclusion does not apply if such discharge, dispersal, release or escape is sudden or accidental.*

R. CUSHMAN & C. STAMM, *supra* note 18, at 253 (emphasis added). The litigation concerning the pollution exclusion has focused on the "sudden and accidental" exception. There is no clear consensus in the courts on whether this exclusion should apply in Superfund fact situations and the issue has generated extensive judicial and academic commentary. *See generally* Annotation, *Construction and Application of Pollution Exclusion Clause in Liability Insurance Policy*, 39 A.L.R. 4TH 1047 (1985); Note, *The Pollution Exclusion Clause Through the Looking Glass*, 74 GEO L.J. 1237 (1986).

[22]This issue is commonly referred to as the "trigger of coverage" issue. It is a particularly significant issue in Superfund insurance cases where coverage is sought for "bodily injury" or "property damage" due to environmental contaminants and it is unclear when such injuries or damage occur. The "trigger" question has been most frequently

property owned by the insured is applied where environmental contamination migrates and damages adjacent land.[23]

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litigated in terms of asbestos-related disease, but a similar analysis is beginning to be applied in property damage cases. There are a number of divergent views, with the circuits apparently divided into four camps.

In Insurance Co. of North America v. Forty-Eight Insulations, Inc., 451 F. Supp. 1230, 1242 (E.D. Mich. 1978), *aff'd*, 633 F.2d 1212 (6th Cir. 1980), *clarified in part on reh'g*, 657 F.2d 814 (6th Cir. 1981), *cert. denied*, 454 U.S. 1109 (1981), the court held that the appropriate "trigger" of coverage was the time of an injured party's "exposure" to asbestos, that is, at the time the asbestos was inhaled, not when the injury is discovered. *See also* Hancock Laboratories, Inc. v. Admiral Ins. Co., 777 F.2d 520 (9th Cir. 1986); Porter v. American Optical Corp., 641 F.2d 1128 (5th Cir.), *cert. denied sub nom.* Aetna Casualty and Surety Co. v. Porter, 454 U.S. 1109 (1981).

In contrast, the First Circuit has adopted the "manifestation" theory which holds that the injury or damage "occurs" within the meaning of the CGL policies, only when it is discovered or becomes manifest. Eagle-Picher Indus. v. Liberty Mut. Ins. Co., 523 F. Supp. 110, 115 (D. Mass. 1981), *aff'd*, 682 F.2d 12 (1st Cir. 1982), *cert. denied sub nom.* Froude v. Eagle-Picher Indus., 460 U.S. 1028 (1983).

The most expansive of the "trigger" theories is the "multiple or continuous" trigger, adopted in Keene Corp. v. Insurance Co. of North America, 667 F.2d 1034 (D.C. Cir. 1981), *cert. denied*, 455 U.S. 1007 (1982). In *Keene*, the court held that every insurer on the risk between the initial exposure and the manifestation was liable for indemnification and litigation expense costs. 667 F.2d at 1044-45.

Finally, the Second Circuit rejected adoption of any of three previous theories, as a matter of law, in American Home Prods. Corp. v. Liberty Mut. Ins. Co., 565 F. Supp. 1485 (S.D.N.Y. 1983), *aff'd as modified*, 748 F.2d 760 (2nd Cir. 1984). Instead, the court adopted an "actual injury" theory which requires a factual case by case evaluation of the type of injury, the period of exposure and the persons affected. 565 F. Supp. at 1497-98.

In Superfund "property damage" cases, no clear trend is apparent as the "exposure" and "manifestation," theories have found favor in the courts. *See* Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO II), 811 F.2d 1180, 1192 n.29 (8th Cir. 1987) ("[w]e adopt the 'exposure' view of coverage."). On rehearing en banc, the court agreed with this finding. 842 F.2d 977, 984 (8th Cir. 1988). *Accord* Fireman's Fund Ins. Cos. v. Ex-Cell-O Corp., 662 F. Supp. 71, 76 (E.D. Mich. 1987). *But see* Mraz v. Canadian Universal Ins. Co., 804 F.2d 1325, 1328 (4th Cir. 1986) (an occurrence is determined at the time the damage is discovered—the "manifestation" theory).

[23]The 1973 standard policy form excludes coverage for damage to "property owned, occupied by or rented to the *insured*." R. Cushman & C. Stamm, *supra* note 18, at 458, 467. In the Superfund context, this straightforward exclusion has been a particular problem because of the nature of the property damage generally involved: damage to subsurface waters not "owned" by the insured and damage to adjacent land which can not practically be segregated from damage to the insured's own land. A majority of courts which have addressed the issue have held that the "owned property" exclusion is not applicable and cleanup costs incurred on the insured's own property to prevent damage to third parties are recoverable under CGL policies. *See* Broadwell Realty Servs., Inc. v. Fidelity and Casualty Co. of N.Y., 218 N.J. Super. 516, 528 A.2d 76 (1987); Township of Gloucester v. Maryland Casualty Co., 668 F. Supp. 394 (D.N.J. 1987); United States v. Conservation Chem. Co., 653 F. Supp. 152, 199-201 (W.D. Mo. 1986); Riehl v. Travelers Ins. Co., 22 Env't Rep. Cas. (BNA) 1544, 1546 (W.D. Pa. 1984), *rev'd on other grounds*, 772 F.2d 19 (3rd Cir. 1985).

Equally complex are the public policy underpinnings. It is clearly the intent of Superfund to make responsible parties pay for cleaning up the waste sites whenever possible.[24] On the other hand, Superfund also expressly preserves agreements to insure, to hold harmless or to indemnify parties found liable for those costs.[25] Indeed, the federal government has been a vocal amicus curiae in favor of liability coverage for Superfund cost recovery judgments.[26] Yet consistent judicial guidelines for this burgeoning new area of the law are few. In effect, the courts are left with the task of determining when or if the "square peg" of statutorily created Superfund liability will fit into the "round hole" of standard CGL policies which are steeped in the traditions of state insurance contract law.[27]

The apparent polarity that results when newly created, retroactive forms of environmental liability clash with traditional principles of insurance law was recently demonstrated in two Superfund insurance coverage cases, *Continental Insurance Companies v. Northeastern Pharmaceutical & Chemical Co.* (NEPACCO),[28] and *Maryland Casualty Co. v. Armco, Inc.*[29] Despite identical policy language and comparable Superfund liability, the Eighth and Fourth Circuits, respectively, initially reached diametrically opposed conclusions on significant insurance coverage questions. The fundamental issues which divided the circuits are whether governmental cleanup costs are a measure of damages or merely an economic loss, and whether CGL policies cover only claims for legal damages, not the governments' requests for equitable relief in the form of restitutionary money judgments. Even with the Eighth Circuit's recent reversal of its decision on the equitable relief/legal damages question in

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[24] 1 Senate Comm. on Environment and Public Works, 97th Cong., 2d Sess., A Legislative History of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (Superfund), Public Law 96-510, Volume 1, at 317-19 (Comm. Print 1983).

[25] CERCLA § 107(e)(1), as amended, 42 U.S.C. § 9607(e)(1) *construed in* Mardan Corp. v. C.G.C. Music, Ltd., 804 F.2d 1454, 1458 (9th Cir. 1986).

[26] *See* Supplemental Brief for the United States as Amicus Curiae on Rehearing En Banc, Continental Ins. Cos. v. Missouri, 815 F.2d 51 (8th Cir. 1987) (No. 85-1940WM); *Mardan*, 804 F.2d at 1454; New York v. General Electric Co., 592 F. Supp. 291 (N.D.N.Y. 1984).

[27] Federal courts adhere to state laws and decisions in interpreting insurance contracts. Erie R.R. v. Thompkins, 304 U.S. 64 (1938); "By preserving such agreements [insurance contracts], Congress seems to have expressed an intent to preserve the associated body of state law under which agreements between private parties would normally be interpreted." *Mardan*, 804 F.2d at 1458.

[28] 811 F.2d 1180 (8th Cir. 1987), *vacated on reh'g en banc*, 842 F.2d 977 (8th Cir. 1988).

[29] 822 F.2d 1348 (4th Cir. 1987).

an en banc rehearing,[30] the courtroom confrontations on these issues have not subsided.[31]

Moreoever, because the circuits' decisions are ostensibly based on state law, the Supreme Court will likely not resolve the controversy.[32] Other courts, insurers and insureds will be forced to enter the fray, insurance rights and obligations will continue to be uncertain, and cleanup costs will undoubtedly escalate. This Note analyzes the Superfund cost recovery issues in light of insurance law principles, the history and language of the standard CGL policies and the underlying public policies. It ultimately suggests that these principles, language and policies support and compel the view that governmental cleanup costs are within the coverage afforded by the CGL policies.

II. Who Gets the Benefit of the Bargain? The Role of Standard Provisions and Principles of Insurance Contract Law

To establish whether a claim falls within the ambit of comprehensive general liability policies, a four part analysis must be undertaken. First, it must be determined whether the claim alleges injury or loss to a third party; second, the actual language of the policy must be examined; third, the meaning of the terms must be ascertained either from the definitions within the policy or from rules of construction where no meaning is contained in the policy; and finally, the policy language and the meaning of terms must be applied to the fact situation which gave rise to the claim.

A. *Third Party Claim Requirement*

CGL policies are third party liability insurance policies that protect insureds against liability that they become legally obligated to pay to others and are distinguished from first party policies which reimburse the insured for losses they directly incur.[33] Hence, a condition precedent

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[30] 842 F.2d 977 (8th Cir. 1988).

[31] *See infra* notes 164-170 and accompanying text.

[32] One court has lamented the judicial inconsistency which colors insurance coverage litigation for environmental contaminant-related injuries and damages, observing,

> Four Circuit Courts of Appeal have reached four different results on the questions at issue ["trigger of coverage"], some diametrically opposed to others, and the Supreme Court has refused to review a single one of those cases, leaving the law in conceptual chaos. The Supreme Court seems unlikely to pass on these questions, moreover, because of its long-standing policy against reviewing Circuit Court rulings that purport to be based upon state law.

American Home Prods. Corp. v. Liberty Mut. Ins. Co., 565 F. Supp. 1485, 1512 (S.D.N.Y. 1983).

[33] A. Windt, Insurance Claims and Disputes: Representation of Insurance Companies and Insureds 239 (1982 & Supp. 1987).

to the CGL insurer's obligation to pay sums on behalf of the insured is that the insured be liable to a third person, by means of either a judgment or a settlement.[34]

B. Duty to Defend/Duty to Indemnify

CGL policies also cover the costs to defend the insured against such third party claims. The duty to defend, however, is generally broader than the duty to pay or indemnify. Because an insurer's duty to defend is generally determined by the allegations in the complaint, it is immaterial whether the insured is ultimately found legally liable.[35] Thus, it is normally the *potential* for coverage which triggers the duty to defend, whereas the duty to indemnify is only imposed when legal liability has been established.[36] However, in Superfund insurance cases the courts are not in agreement on the breadth of that potential for coverage. In *Maryland Casualty Co. v. Armco, Inc.*, the court found that the duty to defend and the duty to indemnify should be interpreted "coterminously" and held that the government's claim for Superfund cost reimbursement was not a claim for damages; therefore, a mere "possibility" of liability did not arise.[37] In contrast, the court in *Fireman's Fund Insurance Cos. v. Ex-Cell-O Corp.*[38] rejected the insurers' claim of no duty to defend because the underlying Superfund claims did not allege damages. "The insurers construe their policies too narrowly: coverage does not hinge on the form of action taken or the nature of the relief sought, but on an actual or threatened use of legal process to coerce payment or conduct by the policy holder."[39]

C. Language of the Standard CGL Policy

CGL policies were developed over forty years ago by insurance industry representatives[40] and were designed to provide commercial enterprises with indemnity for "the broadest spectrum of property damage and personal injury claims brought by third parties arising out of day

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[34]*Id.*

[35]*Insurer's Duty to Defend*, DEFENSE RESEARCH INSTITUTE, INC. 8 (1978).

[36]7C J.A. APPLEMAN, INSURANCE LAW & PRACTICE § 4682 (rev. ed. 1979).

[37]822 F.2d 1348, 1354 (4th Cir. 1987).

[38]662 F. Supp. 71 (E.D. Mich. 1987).

[39]*Id.* at 75.

[40]R. KEETON, BASIC TEXT ON INSURANCE LAW § 2.11(d) (1971). For a discussion of the drafting history of CGL policies, see Sayler & Zolensky, *Pollution Coverage and the Intent of the CGL Drafters: The Effect of Living Backwards*, MEALEY'S LITIGATION REPORTS-INSURANCE 4,425 (1987). The authors, counsel for insureds, contend that the drafters of the standard form contract intended broad coverage for pollution claims and assertions to the contrary by insurers are not supported by the documented CGL drafting history.

to day business operations."[41] The 1966 and 1973 versions of the standard form and the policy definitions contained therein have been widely litigated in Superfund insurance coverage cases. The 1966 version defines "property damage" as "physical injury or destruction of tangible property which occurs during the policy period, including the loss of use thereof at anytime resulting therefrom."[42] An "occurrence" is defined as "an accident, including continuous or repeated exposure to conditions, injury or property damage neither expected or intended from the standpoint of the insured."[43] The word "damages" "includes . . . damages for loss of use of property resulting from property damage."[44] A "pollution exclusion"[45] was incorporated into the 1973 standard CGL policy. With the onslaught of new forms of statutory liability for pollution-related events, the standard form has continued to be revised. Today, the new standard form, effective in 1986, virtually eliminates the potential for any such coverage.[46]

D. Choice of Law in Insurance Contract Interpretation

A federal court must determine which substantive state law should apply in deciding questions of insurance contract construction.[47] In the

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[41]Chesler, Rodberg, & Smith, *Patterns of Judicial Interpretation of Insurance Coverage for Hazardous Waste Site Liability*, 18 RUTGERS L. J. 9, 14 (1986).

[42]R. CUSHMAN & C. STAMM, *supra* note 18, at 470.

[43]*Id.*

[44]*Id.* at 460.

[45]*See supra* note 21.

[46]The new exclusion reads:

This insurance shall not apply to:

(1) "Bodily injury" or "property damage" arising out of the actual, alleged or threatened discharge, dispersal, release or escape of pollutants:

- (a) at or from premises you own, rent or occupy;
- (b) at or from any site or location used by or for you or others for the handling, storage, disposal, processing or treatment of waste;
- (c) which are at any time transported, handled, stored, treated, disposed of or processed as waste by or for you or any person or organization for whom you may be legally responsible; or
- (d) at or from any site or location on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations;
  - (i) if the pollutants are brought on or to the site or location in connection with such operations; or
  - (ii) if the operations are to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize the pollutants.

(2) Any loss, cost or expense arising out of any governmental direction or request that you test for, monitor, clean up, remove, contain, treat, detoxify or neutralize pollutants.

1984 Insurance Office Commercial General Liability Coverage Form, p. 2.

[47]Where the federal courts are uncertain about the application of state law, they

principal cases both hazardous waste sites giving rise to the underlying Superfund actions are in the state of Missouri. Yet in the insurance coverage actions, the law of Maryland was applied in *Armco*[48] and Missouri law to the *NEPACCO* site[49] because the parties stipulated that those state laws, respectively, would apply. The choice of which state law to apply has become a formidable judicial task in Superfund insurance actions because there often are multiple potentially responsible parties who, in the course of business, may have generated, transported, stored or disposed of wastes at sites all across the country.

In *Independent Petrochemical Corp. (IPC) v. Aetna Casualty and Surety*,[50] the District of Columbia District Court was faced with determining which choice of law provision would apply to an insurance action arising out of Superfund dioxin-related injury and property damage suits. The actions which gave rise to the suits occurred in Missouri, but the insurance contracts of some of the multiple defendants were negotiated and agreed upon in several other states. The court found the general choice of law factors relating to place of contract negotiation, contract performance, and place of business or incorporation[51] to be difficult and burdensome to apply "due to the diverse nature of the parties and places of contracting."[52] Instead, the court focused on the location of the insured risk. Because the risk was of bodily injury or property damage arising out of IPC's alleged improper waste disposal in Missouri, the court found that Missouri law governed the trigger of coverage issue.[53]

E. General Rules of Insurance Contract Construction

Once the choice of law issue is resolved, other key insurance law principles become relevant. These general rules are not only essential to

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will certify questions to the state's high court. *See, e.g.*, Eli Lilly & Co. v. Home Ins. Co., 482 N.E.2d 467 (Ind. 1985), *certified question*, 764 F.2d 876 (D.C. Cir. 1985). In *Lilly*, the Indiana Supreme Court was asked what "trigger" of coverage the state would apply in a delayed bodily injury claim. The court adopted the multiple trigger interpretation of the "occurrence" issue in a CGL policy arising out of DES-related claims. *Id.* at 471. This result puts in question the holding in United States Fid. and Guar. Co. v. American Ins. Co., 169 Ind. App. 1, 345 N.E.2d 267 (1976), where the court adopted the "manifestation" trigger of coverage in a property damage case. *See* cases cited *supra* note 22.

[48]Maryland Casualty Co. v. Armco, Inc., 822 F.2d 1348, 1352 (4th Cir. 1987).

[49]Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co., 811 F.2d 1180, 1184 n.10 (8th Cir. 1987), *vacated on reh'g en banc*, 842 F.2d 977 (8th Cir. 1988).

[50]654 F. Supp. 1334 (D.D.C. 1986).

[51]*See* 2 COUCH, COUCH ON INSURANCE 2D §§ 16:2, 16:10, 16:12, 16:20 (rev. ed. 1984).

[52]654 F. Supp. at 1356.

[53]*Id.*

understanding the insurance relationship, but are of fundamental importance to understanding the holdings in the principal cases.

The basic rule in interpreting insurance contracts is if the terms of the policy are clear and unambiguous, the language is to be construed according to its ordinary and popular meaning,[54] that is, "the meaning a reasonably prudent layman would infer."[55] Courts have relied on standard dictionaries to determine the popular meaning of words[56] and generally "the fact that the policy provision would be unambiguous to one trained in the law or insurance is of no significance."[57] However, if the language of the policy is susceptible to more than one meaning, most states have adopted the rule that any ambiguity or uncertainty in an insurance policy should be resolved against the insurer, and "[a]n ambiguous insurance policy should be construed to further the policy's basic purpose of indemnity."[58]

The rule that ambiguous terms are to be construed as a matter of law against the drafter of the policy is based on the view that insurance contracts, particularly standard forms, are adhesion contracts.[59] The insureds generally lack equal bargaining power to negotiate policy terms and, thus, "courts should strive to give effect to the reasonable expectations of the insured."[60] In some Superfund insurance coverage cases, as well as in other litigation involving commercial business insureds,

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[54]13 J.A. Appleman, Insurance Law and Practice § 7384 (rev. ed. 1976 & Supp. 1987). *See also* A. Windt, *supra* note 33, at 225.

[55]"It is black-letter law that the terms of an insurance policy are to be construed according to the meaning a reasonably prudent layman would infer." Maryland Casualty Co. v. Armco, 822 F.2d 1348, 1352 (4th Cir. 1987) (citing Pacific Indem. Co. v. Interstate Fire & Casualty Co., 302 Md. 383, 388, 488 A.2d 486, 488 (1985)).

[56]Southern Guar. Ins. Co. v. Duncan, 131 Ga. App. 761, 206 S.E.2d 672 (1974) (dictionaries supply the plain, ordinary and popular sense of words used in contracts). *See also supra* note 54.

[57]A. Windt, *supra* note 33, at 232. *See* Acands, Inc. v. Aetna Casualty & Surety Co., 764 F.2d 968, 973 (3d Cir. 1985) (rule that insurance policy must be strictly construed against insurers applied even when insured is large commercial entity that bargained with insurance company). *But see infra* text accompanying notes 61-67.

[58]Eli Lilly & Co. v. The Home Ins. Co., 482 N.E.2d 467, 470 (Ind. 1985).

[59]3 A. Corbin, Corbin on Contracts § 559 at 265-267 (1960).

[60]*Lilly*, 482 N.E.2d at 471. The doctrine of reasonable expectations was created specifically to aid in the interpretation of ambiguities within insurance contracts and is a corollary of the principle of resolving ambiguities against the insurer. It was first articulated by Robert E. Keeton who stated, "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations." R. Keeton, Basic Text on Insurance § 36.3(a), at 351 (1971). The doctrine has been adopted by a number of courts and is favored by many commentators. *See generally* Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 Va. L. Rev. 1151 (1981).

insurers and their counsel contend that "the 'general rule' requiring construction of an insurance policy against the insurer should have no application" because the policies "have been negotiated by parties with substantially equal bargaining power."[61] While some courts have refused to automatically place the responsibility for ambiguous terms on the insurer in situations involving sophisticated business insureds who negotiated their policy terms and were represented by trained insurance and legal counsel,[62] most courts and commentators have been reluctant to discard the *contra insurer* rule.[63] Indeed, a number of courts follow the rule that once an ambiguity is discovered, even if the insured is a sophisticated entity with apparent equal bargaining power, the policy will be construed against the insurer and no quantum of evidence on issues of authorship, intent or cause is relevant.[64] Other courts apply the *contra insurer* rule as a matter of law only if an evaluation of pertinent extrinsic evidence is insufficient to establish the parties' true intent.[65] In Maryland, the courts follow yet another procedure. If the language of an insurance contract is ambiguous, extrinsic evidence is admissible to show the parties' intent and "if disputed factual issues are presented by the evidence bearing on the ambiguity, construction of the contract is for the jury."[66] However, while the resolution of insurance contract interpretation is a matter for the trier of fact in Maryland,

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[61]Ostrager and Ichel, *The Role of Bargaining Power Evidence in the Construction of the Business Insurance Policy: An Update*, 18 Forum 577 (1983).

[62]Hartford Accident and Indem. Co. v. Gulf Ins. Co., 776 F.2d 1380 (7th Cir. 1985); Loblaw, Inc. v. Employer's Liab. Assurance Corp., 85 A.D.2d 880, 446 N.Y.S.2d 743 (1981).

[63]Eagle-Picher Indus. v. Liberty Mut. Ins. Co., 682 F.2d 12, 21 n.6 (1st Cir. 1982); Pan Am. World Airways, Inc. v. Aetna Casualty & Surety Co., 505 F.2d 989, 1002 (2d Cir. 1974); Owens-Illinois, Inc. v. Aetna Casualty & Surety Co., 597 F. Supp. 1515, 1523-24 (D.D.C. 1984). *See also supra* note 61, at 577 n.2 (collecting decisions and commentaries favoring the *contra insurer* rule).

[64]Eli Lilly & Co. v. The Home Ins. Co., 482 N.E.2d 467, 470 (Ind. 1985).

[65]One court described the relationship of extrinsic evidence to insurance contract construction:

> An ambiguity in a policy provision induces a construction most favorable to the insured—but does not foreclose evidence for interpretation. The principle that an ambiguous adhesion provision shall be given an intendment favorable to the adherent rests on the public policy that the inept drafter of a form had the resources to do better. The principle that an ambiguous adhesion provision shall be open to interpretation by evidence as well as by the written words rests on the role of the law to protect the reasonable expectations of the parties induced by the agreement.

Estrin Constr. Co. v. Aetna Casualty & Surety Co., 612 S.W.2d 413, 419 (Mo. Ct. App. 1981).

[66]Truck Ins. Exch. v. Marks Rentals, Inc., 288 Md. 428, ____, 418 A.2d 1187, 1190 (1980).

"the ambiguity is to be resolved against the company which prepared the policy and in favor of the insured."[67]

The question of whether terms in the standard CGL policy are given their common and popular meaning or are deemed ambiguous and construed to give effect to the reasonable expectations of the insured, is of particular significance in Superfund insurance coverage litigation. Policy provisions must be applied to newly-created liabilities for disposal practices which may well have been conducted in good faith and in compliance with applicable laws. In the principal cases that follow, each of these traditional rules of construction plays a significant role.

III. The Principal Cases

A. *Continental Insurance Cos. v. Northeastern Pharmaceutical & Chemical Co.*[68]

In *NEPACCO II*, the insurer filed suit against its insured seeking a declaratory judgment that it had no duty to defend or indemnify the chemical company for liability arising out of the government's Superfund cost recovery suit (the "EPA" suit)[69] in which NEPACCO and its corporate officers were found jointly and severally liable under Superfund for the cost of clean up of a hazardous waste site in Missouri.[70] The State of Missouri intervened in *NEPACCO II* to protect its interests arising out of claims that it made against NEPACCO in another suit, and counterclaimed against the insurer for coverage in that action, the "IPC" suit.[71]

Interpreting Missouri law, the district court found that an insurer is liable only for "bodily injury or property damage which occurs during the policy period" and held that an "occurrence" is the time the loss or damage was sustained rather than the time when the negligence or

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[67] Government Employees Ins. v. DeJames, 256 Md. 717, 720, 261 A.2d 747, 749 (1970).

[68] 811 F.2d 1180 (NEPACCO II) (8th Cir. 1987), *vacated on reh'g en banc*, 842 F.2d 977 (8th Cir. 1988).

[69] United States v. Northeastern Pharmaceutical & Chemical Co. (NEPACCO I), 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 108 S. Ct. 146 (1987).

[70] *Id.* At the time of the *NEPACCO I* trial, NEPACCO was a defunct "shell" corporation. 810 F.2d at 742. Following the decision in *NEPACCO I*, the United States instituted a garnishment proceeding to recover its $155,171.93 judgment against NEPACCO. United States v. Continental Ins. Co., No. 85-3069 (W.D. Mo. filed Feb. 25, 1985). The district court stayed the garnishment action pending the resolution of the insurance action.

[71] Missouri v. Independent Petrochemical Co., 22 Env't Rep. Cas. (BNA) 1735 (E.D. Mo. 1985).

wrongful act was committed.[72] It held that the governmental entities did not sustain a compensable loss until they incurred remedial or removal costs. Because these costs were incurred after the policy expired, there was no occurrence to give rise to the insurer's liability and the court granted summary judgment to Continental (no coverage for the "EPA" suit or the "IPC" suit).[73]

On appeal, a panel of the Eighth Circuit reversed the decision concerning Continental's liability in the "EPA" suit, holding that state and federal governments suffer "property damage" at the time hazardous wastes are "released" into the environment, and CERCLA cleanup costs are a recoverable measure of damages for this environmental property damage.[74] The court rejected the insurer's contention that only actual owners of land on which hazardous wastes are improperly disposed sustain "property damage" and any governmental injury is merely economic injury. The court held injury to governmental "quasi-sovereign" interests in natural resources constitutes "property damage" within the meaning of CGL policies.[75]

The panel also rejected the lower court's reasoning that the governments did not incur a loss until such time as they incurred cleanup costs. It held that environmental damage occurs at the moment hazardous wastes are improperly released, and a liability policy in effect at the time this damage is caused provides coverage for the subsequently incurred costs of cleaning up the wastes.[76] Finally, the panel affirmed the lower court's ruling that the insurer was not liable in the "IPC" suit because in that case the state sought reimbursement for cleanup costs arising from contamination which did not take place until 1974, after the policies expired.[77]

Judge McMillian[78] dissented only from the part of the panel opinion which held cleanup costs under Superfund are compensatory damages for "property damage" within the meaning of the CGL policies.[79] In his view, cleanup costs constitute equitable monetary relief, but not legal

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[72]Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co., No. 84-5034-CV-S-4 (W.D. Mo. June 25, 1985) (WESTLAW, Federal DCTU database).

[73]*Id.*

[74]Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO II), 811 F.2d 1180, 1191 (8th Cir. 1987), *vacated on reh'g en banc*, 842 F.2d 977 (8th Cir. 1988).

[75]811 F.2d at 1187.

[76]*Id.* at 1191.

[77]*Id.* at 1192.

[78]Judge McMillian authored the opinion in *NEPACCO I*, the underlying "EPA" suit, and the en banc decision after rehearing.

[79]811 F.2d at 1193 (McMillian, J., concurring in part and dissenting in part).

damages.[80] Referring to "black letter" insurance law, Judge McMillian found that "claims for equitable relief are not claims for 'damages' under liability insurance contracts."[81] On rehearing en banc, a sharply divided[82] Eighth Circuit found Judge McMillian's dissent and the reasoning articulated in *Maryland Casualty Co. v. Armco, Inc.*[83] more persuasive and held that CERCLA cleanup costs are not claims for damages under CGL policies.[84] The court acknowledged that outside the insurance context the term "damages" is ambiguous, but it found that no such ambiguity exists when interpreting the terms of a standard insurance policy.[85] Once the court decided the insurer had no duty to defend or indemnify because the governments' claims for cleanup costs were not legal damages, it declined to reach the other issues discussed in the panel decision. The court made clear, however, that it agreed with the panel that environmental contamination can constitute property damage within the meaning of CGL policies and that Missouri would likely adopt the "exposure" trigger of coverage theory.[86]

B. *Maryland Casualty Co. v. Armco, Inc.*

As the *NEPACCO* decisions suggest, the District Court of Maryland concluded that Superfund cleanup costs are not within the coverage afforded by the CGL policies.[87] This conclusion was affirmed on appeal by the Fourth Circuit in *Maryland Casualty Co. v. Armco, Inc.*,[88] an action arising out of a suit brought against the defendant Armco by the United States under Superfund for recovery of cleanup costs and remedial action at another hazardous waste site in Missouri, known as the CCC litigation.[89]

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[80]*Id.* at 1194 (McMillian, J., concurring in part and dissenting in part).

[81]*Id.* (citations omitted).

[82]Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO), 842 F.2d 977, 987 (8th Cir. 1988) (Heaney, J., dissenting). The final en banc vote was 4 to 3, as Judge Ross took senior status on June 13, 1987, eight months prior to the issuance of the opinion. *Id.* at 978.

[83]822 F.2d 1348 (4th Cir. 1987).

[84]842 F.2d at 987.

[85]*Id.* at 985.

[86]*Id.* at 983-84.

[87]Maryland Casualty Co. v. Armco, Inc., 643 F. Supp. 430 (D. Md. 1986).

[88]822 F.2d 1348 (4th Cir. 1987).

[89]*Id. See* United States v. Conservation Chem. Co., 681 F. Supp. 1394 (W.D. Mo. 1988); 661 F. Supp. 1416 (W.D. Mo. 1987); 653 F. Supp. 152 (W.D. Mo. 1986); 628 F. Supp. 391 (W.D. Mo. 1985); 619 F. Supp. 162 (W.D. Mo. 1985); 589 F. Supp. 59 (W.D. Mo. 1984). As the string of citations suggests, the CCC litigation is one of the largest and more complex Superfund actions to date. The United States' claim sought recovery of $2,541,107.40 for response costs it incurred in cleaning up the industrial chemicals

In the CCC litigation, Armco was one of many original waste generators allegedly responsible for environmental contamination. It filed a third-party complaint against Conservation Chemical Company's (CCC) insurer, Maryland Casualty, in the Missouri district court where the CCC litigation was being tried, alleging it was an intended beneficiary of the site operator's insurance policies. The Missouri district court adopted a Special Master's report which found CCC, Armco, and others liable for the Superfund cleanup costs and held that this environmental harm constituted "property damage" for purposes of the insurance policy between CCC and Maryland Casualty.[90] Accordingly, the district court held that Maryland Casualty was under an obligation to indemnify and defend Armco in the CCC litigation.[91] Shortly after the Missouri district court issued its Order, a partial settlement was reached between the insurer and the original waste generators (including Armco). Subsequently, Chief Judge Wright vacated the Order as to the settling parties.[92]

Because Armco's own insurance policy with Maryland Casualty was written and signed in Maryland, this insurance action was brought in the District Court of Maryland, and Maryland's insurance law was applied.[93] However, the insurance policy between Maryland Casualty and Armco contained nearly identical language to the Maryland Casualty—CCC site operator's policy at issue in the Missouri litigation.[94]

The Maryland district court found that action taken by the Missouri district court did not render the present controversy *res judicata* and did not give rise to collateral estoppel.[95] It held that Maryland Casualty was under no duty to defend or indemnify Armco in the CCC litigation because that litigation involved a claim for equitable relief, not a legal claim which Maryland Casualty must defend or indemnify.[96]

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waste facility in Kansas City. 628 F. Supp. at 404. The government also sought injunctive relief to compel the defendants to undertake a long term remedial action program to permanently clean up the site. In terms of environmental contamination, the undisputed facts are that over 50 million gallons of waste material were transported to the site during its more than twenty years of operation. "By defendants' own estimates, more than 22,000 pounds of hazardous substances are being discharged into the Missouri River and Blue River each year. . . . These substances could continue to be discharged for many years . . . into areas likely to be directly encountered by humans or other living organisms," including public water supplies and agricultural lands. 619 F. Supp. at 182-84.

[90]653 F. Supp. at 187-94.

[91]*Id.* at 204-16.

[92]*Id.* at 158.

[93]*See supra* notes 47-49 and accompanying text.

[94]*Armco*, 822 F.2d at 1351.

[95]Maryland Casualty Co. v. Armco, Inc., 643 F. Supp. 430, 433-34 (D. Md. 1986). The Circuit affirmed the lower court's view stating, "[w]e decline to hold that the recommendations of a special master, which have been vacated, rise to the level of a 'final judgment' in order to estop the present litigation." 822 F.2d at 1355.

[96]643 F. Supp. at 432.

The Fourth Circuit affirmed, holding that the term "damages" has a technical meaning distinguishable from claims for injunctive or restitutionary relief.[97] It explicitly disagreed with *United States Aviex Co. v. Travelers Insurance Co.*[98] and the *NEPACCO* panel opinion,[99] both of which held to the contrary. The court reasoned that an insurer has to reimburse its insured only when the insured is obligated to pay damages that result from injury, which in the insurance context means damages in the legal sense. It held that the cost to Armco of complying with the directives of a regulatory agency are not covered within the terms of the insurance policy.[100]

IV. Governmental Cleanup Costs: A Measure of Legal Damages or a Noncompensable Economic Loss

It would be simple to conclude that Superfund insurance coverage issues are now resolved with the Eighth Circuit's wholesale adoption of the *Armco* definition of legal "damages." However, there are still fundamental differences of view in the opinions that transcend the peculiarities of state law and will have significant bearing on future Superfund insurance actions arising in other states. The first of these issues is whether the government's claim for reimbursement of cleanup costs is a third party claim.

The *NEPACCO* panel decision strongly refuted the insurer's contention that only actual owners of the land suffer property damage and therefore are the only entities qualified to be third party claimants under CGL policies. In the court's view (left undisturbed on rehearing) "state and federal governments suffer injury to their 'quasi-sovereign' interests when pollutants are released into the soil, water, and air within their jurisdiction."[101] The court found support for its conclusion that Superfund cost recovery claims are within the coverage provided by the policies because the policy definition of "property damage" is "injury or loss to tangible property."[102] In its view, "the improper release of toxic wastes may cause 'property damage' not only to the actual owner . . . but also to state and federal governments because of their 'interest independent of and behind the titles of its citizens in all the earth and

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[97]822 F.2d at 1352.

[98]125 Mich. App. 579, 336 N.W.2d 838 (1983). *See infra* text accompanying notes 166-74 and accompanying text.

[99]Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO II), 811 F.2d 1180, 1189 (8th Cir. 1987), *vacated on reh'g en banc*, 842 F.2d 977 (8th Cir. 1988).

[100]*Armco*, 822 F.2d at 1352.

[101]*NEPACCO II*, 811 F.2d at 1185.

[102]*Id.* at 1186.

air within [their] domain.' "[103] Thus, the court held that the governments, like owners of private property, met the first requirement for coverage: they asserted a third party claim.

But the Fourth Circuit apparently disagrees. In *Mraz v. Canadian Universal Insurance Co.*,[104] an action brought against the insurer to defend and indemnify under a CGL policy for liabilities arising under a Superfund cost recovery claim, the court acknowledged that the governments' cost recovery claim alleged that property damage occurred, but "there [we]re no allegations that *plaintiffs* sustained any property damage or that they even ha[d] the requisite interest in the Leslie site."[105] In this court's view, even though the governments' complaint alleged that the release of hazardous substances caused contamination of land and water, that contamination was not the injury for which the governments sought relief. Rather, the environmental contamination was "merely a factual predicate of the cost reimbursement claim."[106]

When both the policy language and the purpose of Superfund are examined in tandem, the Eighth Circuit's reasoning that governments do have an identifiable interest in protecting the environment when they take direct action to clean up a hazardous waste site is far sounder than the Fourth Circuit's narrow view. First, it is the very purpose of the federal Superfund law to vest in the U.S. government the authority to "protect public health and environment from releases of hazardous substances and waste."[107] If the government has no "interest" in the environmental property damage caused by these wastes, there would be no necessity for its cleanup authority. Second, the insurance policies at issue provide coverage for liability incurred "because of property damage." It does not require or specify that coverage is limited to claims by actual owners of the contaminated property.

A more critical issue is whether the governments' claims are compensatory damages for "property damage" or, instead, an economic loss separate and distinct from the hazardous waste contamination. Because neither *Mraz* nor the *NEPACCO* opinions focus on the meaning of the

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[103]*Id.* at 1187.

[104]616 F. Supp. 1173 (D. Md. 1985), *rev'd*, 804 F.2d 1325 (4th Cir. 1986). The *Mraz* decision is discussed herein because the *Armco* opinion did not contain the circuit's views on whether cleanup costs are a measure of damages or an economic loss. However, the Fourth Circuit declined to base its decision in *Armco* on *Mraz* because the parties did not raise the same issues. 822 F.2d at 1354 n.2. Another reason for the court's reluctance to rely on *Mraz* may be the presence of an alternative holding in that case which "alone would fully support the reversal of the judgment of the district court." 804 F.2d at 1330 (Ervin, J., concurring).

[105]804 F.2d at 1329 (emphasis in original).

[106]*Id.* at 1328.

[107]*Superfund I*, *supra* note 1, at 1.

phrase "*because of* property damage," it is necessary to return to the actual language of the insurance policies to resolve this issue.

The CGL definition of "property damage" is "injury to tangible property."[108] In reviewing that definition, the *Mraz* court correctly stated that "response costs are not themselves property damage."[109] However, it then concluded, without citation to any authority, that Superfund "response costs are an economic loss."[110] On the other hand, the *NEPACCO* panel, interpreting the same phrase, found that "once there is property damage—here environmental contamination—then the damages that flow from that property damage—here, cleanup costs—are recoverable."[111] In effect, the Fourth Circuit adopted the position that the " 'property damage' definition is the ultimate determinant of the scope of coverage for property damage liability."[112] In contrast, the Eighth Circuit panel begins its analysis by finding that hazardous waste contamination causes property damage and the consequences of that damage, the removal costs, are compensable *because of* that damage.[113]

In light of the basic tenets of contract law that all terms are to be given effect and the contract is to be interpreted as a whole,[114] the words "because of" must serve some purpose in the policy provision. The CGL policies do not define these words. In the absence of a policy definition, the words in an insurance policy are generally given their "ordinary and common meaning."[115] The generally accepted meaning of "because of" is: "on account of," "as a consequence of" or "by reason of."[116]

This common meaning accorded the words "because of" has found favor with the courts. In *Globe Indemnity Co. v. People*,[117] an insurer appealed from a judgment that it was obligated under its CGL policy to satisfy any money judgment the state of California obtained from

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[108]*See supra* note 42 and accompanying text.

[109]804 F.2d at 1329.

[110]*Id.*

[111]Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO II), 811 F.2d 1180, 1189 (8th Cir. 1987), *vacated on reh'g en banc*, 842 F.2d 977 (8th Cir. 1988).

[112]Note, *Liability Coverage for "Damages Because of Property Damage" Under the Comprehensive General Liability Policy*, 68 MINN. L. REV. 795, 815 (1984). The author suggests that no case law directly supports this narrow view of the scope of liability coverage for consequential damages arising from property damage.

[113]*NEPACCO II*, 811 F.2d at 1187.

[114]WINDT, *supra* note 33, at 226 n.3 (collected cases). 13 J.A. APPLEMAN, *supra* note 54, at § 7385.

[115]*See supra* notes 54-56 and accompanying text.

[116]13 J.A. APPLEMAN, *supra* note 54, at § 7385; *see also* Note, *supra* note 112, at 818 nn.117-20.

[117]43 Cal. App. 3d 745, 118 Cal. Rptr. 75 (1974).

its insured for fire suppression costs. The *Globe* policy, like the policies at issue in most Superfund actions, provides that "the company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages . . . because of . . . property damage. . . ."[118] Under the California statute, liability for fire suppression costs could be incurred only if a fire escaped to property belonging to others and caused damage thereto.[119] The court observed that under California law, the word "property" refers to physical or tangible property. Thus, the only issue was whether it was "semantically permissible to say fire suppression costs are sums the insureds became legally obligated to pay *because of* damage to tangible property."[120] The court answered the question in the affirmative. It found that liability for fire suppression costs under the applicable statute can arise only if the fire causes damage to property, the property was tangible, and the costs were incurred to prevent further damage to tangible property. Thus, it held that the government's costs were "a sum recoverable under the policies."[121]

In the pollution context, where cleanup costs like the fire suppression cost in *Globe* are incurred "because of" damage to tangible property, other courts have found such costs recoverable under CGL policies.[122] In *Port of Portland v. Water Quality Insurance Syndicate,*[123] an action by the insured to recover the cost of containing and cleaning up an oil spill on the Willamette river in Oregon, the Ninth Circuit affirmed the lower court's holding that the "reasonable, enlightened view" is that "discharge of pollution into water causes damages to tangible property and hence cleanup costs are recoverable under a property damage liability clause."[124]

In Superfund insurance coverage actions, still other courts have rejected the Fourth Circuit's narrow view that cleanup costs are not themselves property damage and therefore are noncompensable under CGL policies.[125] Indeed, the court in *New Castle County v. Hartford*

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[118] *Id.* at 748, 118 Cal. Rptr. at 77.

[119] *Id.* at 750, 118 Cal. Rptr. at 79.

[120] *Id.* (emphasis in original).

[121] *Id.* at 751, 118 Cal. Rptr. at 79.

[122] *See* Lansco, Inc. v. Department of Envtl. Protection, 138 N.J. Super. 275, 283-84, 350 A.2d 520, 524-25 (Ch. Div. 1975), *aff'd*, 145 N.J. Super. 433, 368 A.2d 363 (App. Div. 1976), *cert. denied*, 73 N.J. 57, 372 A.2d 322 (1977) (state statutory liability for costs of cleaning up oil spill within coverage afforded by CGL policy); Kutsher's Country Club Corp. v. Lincoln Ins. Co., 119 Misc. 2d 889, 892, 465 N.Y.S.2d 136, 139 (N.Y. Sup. Ct. 1983) (state claim for reimbursement of costs incurred in cleaning up oil spill constitutes "property damage" under the terms of CGL policy).

[123] 796 F.2d 1188 (9th Cir. 1986).

[124] *Id.* at 1194, *aff'g in part* 549 F. Supp. 233 (1982).

[125] United States v. Conservation Chem. Co., 653 F. Supp. 152, 190-91 (W.D. Mo.

Accident and Indemnity Co.[126] noted:

> This court disagrees with the holding and reasoning of *Mraz*. To trigger coverage under the policies, the Federal Government in United States v. New Castle County need not allege that it suffered property damage. Under the terms of the policy, the underlying claim need only require the insured "to pay damages *because of* bodily injury or property damage." . . . The Court finds that all of the underlying lawsuits at issue are included within the policies' definition of damages.[127]

Similarily, in *Solvents Recovery Service of New England v. Midland Insurance Co.*,[128] the court rejected the insurer's contention that the government's costs to remove drums from the Enviro-Chem hazardous waste site in Zionsville, Indiana, did not constitute "damage to tangible property." The court acknowledged that the act of removing the drums was not itself "property damage." But it observed "this contention ignores the fact that the very presence of the drums prompted the EPA to seek removal of the drums. And, that is the damage which rendered the [insured] legally obligated, as opposed to property damage itself."[129] In holding that the insurer was obligated to indemnify for the government's removal costs, the New Jersey court relied on *United States v. Conservation Chemical Co.*,[130] the underlying suit in the *Armco* action, where the court found that improper hazardous waste disposal "constitutes actions for injury to or destruction of tangible property" as defined in the CGL policies.[131]

In these and other similar cases,[132] the words "because of" were either explicitly or implicitly given their ordinary and common meaning;

1986) (cleanup costs incurred by, or to be charged against, an insured constitute "property damage" within the meaning of the term as used in a CGL policy); Independent Petrochemical Corp. v. Aetna Casualty & Surety Co., Civ. No. 83-3347, slip op. 23 (D.D.C. May 2, 1986) (WESTLAW, Federal DCTU database) (sums denominated as "cleanup" costs constitute damages for purposes of liability insurance coverage); Broadwell Realty Servs., Inc. v. Fidelity & Casualty Co. of N.Y., 218 N.J. Super. 516, 528 A.2d 76 (1987); Buckeye Union Ins. Co. v. Liberty Solvents and Chems. Co., 17 Ohio App. 3d 127, 477 N.E.2d 1227 (1984); Riehl v. Travelers Ins. Co., 22 Env't Rep. Cas. (BNA) 1544 (W.D. Pa. 1984), *rev'd on other grounds*, 772 F.2d 19 (3d Cir. 1985).

[126] 673 F. Supp. 1359 (D. Del. 1987).

[127] *Id.* at 1366 (emphasis in original).

[128] No. L-25610-83 (N.J. Super. Ct. Law Div. Nov. 17, 1986), *reported in* Hazardous Waste Lit. Rep. (Andrews) 10,453 (February 16, 1987), *rev'd on other grounds*, 218 N.J. Super. 49, 526 A.2d 1112 (1987).

[129] *Id.* at 10,454.

[130] 653 F. Supp. 152 (W.D. Mo. 1986).

[131] *Id.* at 194.

[132] *See* cases cited *supra* notes 122 and 125.

that is, cleanup costs incurred "as a consequence of" damage to tangible property are within the coverage afforded by CGL policies. In each case, there was an established causal nexus between the cleanup costs and the property damage. In Superfund actions where a causal connection[133] must also exist to render a responsible party liable for the cleanup costs, the "reasonable and enlightened view" should be that hazardous waste contamination is damage to tangible property and cleanup costs are sums compensable because of, and arising from, that property damage.

V. Equitable Relief v. Legal Damages

In holding that the insurer had no duty to defend or indemnify its insured in the underlying Superfund action, the *Armco* court never addressed the issue whether governmental cleanup costs are compensable under CGL policies *because of* property damage. The Fourth Circuit limited its inquiry to interpretation of the first part of the insurance clause: "to pay on behalf of the insured all sums which the insured shall become legally obligated to pay *as damages*."[134]

In *Armco* the Fourth Circuit stated that "[i]t is black letter law that the terms of an insurance policy are to be construed according to the meaning a reasonably prudent layman would infer,"[135] and confirmed that it is a basic "rule of construction that terms of an insurance contract are to be given their ordinary meaning."[136] Yet it adopted what it described as a "somewhat narrow, technical definition of damages."[137] In the court's view " 'damages,' as distinguished from claims for injunctive or restitutionary relief, include 'only payments to third persons when those persons have a legal claim for damages . . . .' "[138] To give this rather circular definition clearer meaning, the court held that the

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[133]CERCLA § 107 does not mention causation. Courts interpreting this provision have applied a loose causation test and have not required that the government prove the traditional cause-in-fact and proximate cause tort concepts. Rather, the government need only establish a relationship between the generator defendants and the waste site. That is, it need only prove that a generator disposed of a hazardous substance at the site, and that hazardous substances like those placed there by the defendant are present at the site. United States v. Wade, 577 F. Supp. 1326, 1333 (E.D. Pa. 1983). As one court stated, Section 107 "does not require the government to match the waste found to each defendant as if it were matching fingerprints." United States v. Ottati & Goss, Inc., 630 F. Supp. 1361 (D.N.H. 1985). For a review of the chemical industry and government's arguments on causation, see *Superfund I*, *supra* note 1, at 41-45.

[134]R. Cushman & C. Stamm, *supra* note 18, at 458, 467 (emphasis added). *See* Maryland Casualty Co. v. Armco, Inc., 822 F.2d 1348, 1351-54 (4th Cir. 1987).

[135]822 F.2d at 1352.

[136]*Id.*

[137]*Id.*

[138]*Id.*

underlying Superfund cost recovery claim was a form of equitable, remedial relief, "not damages in the legal sense."[139] On rehearing en banc, the *NEPACCO* court did not add to or clarify this "technical" definition, choosing instead to adopt the Fourth Circuit view *in toto* without citation to independent authority.[140]

There is little doubt that the circuits are correct in viewing Superfund cost recovery claims as equitable rather than legal in nature.[141] However, in Maryland and Missouri "the test [for interpreting insurance contracts] is what a reasonably prudent layperson would attach to the term."[142] Had the courts adhered to this test to determine the meaning of "damages," it is not at all clear that a "reasonable layman" would infer or understand the legal distinction "between a money judgment rendered on a cause of action sounding in equitable restitution and a money judgment sounding in law."[143] Courts have often consulted dictionaries to assist them in determining what meaning the elusive, but ever present, "reasonably prudent person" would afford such terms.[144] Had the Fourth Circuit consulted such sources, it would have found that the standard dictionary definition of "damages" is "compensation in money imposed by law for loss or injury."[145] Again, the definition would not readily

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[139]*Id.*

[140]Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO), 842 F.2d 977, 986 (8th Cir. 1988).

[141]In determining whether defendants in Superfund cost recovery actions have a right to jury trial, the courts have stated that the governments' actions are equitable, not legal, because the government is seeking restitution for costs it has incurred. Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO I), 810 F.2d 726, 749 (8th Cir. 1986), *cert. denied*, 108 S. Ct. 146 (1987); United States v. Mottolo, 605 F. Supp. 898 (D.N.H. 1985); United States v. Georgeoff, 22 Env't Rep. Cas. (BNA) 1601 (N.D. Ohio 1984). *But see infra* text accompanying notes 152-62.

[142]*Armco*, 822 F.2d at 1352 (Maryland law); *NEPACCO*, 842 F.2d at 985 (Missouri law).

[143]Supplemental Brief for the United States As Amicus Curiae on Rehearing En Banc at 6, Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co., 815 F.2d 51 (8th Cir. 1987) (No. 85-1940WM). The government contended that it is not until the first year of law school that such distinctions acquire their specialized meanings. *See also* Hearst Corp. v. Hughes, 297 Md. 112, ____, 466 A.2d 486, 489 (1983) ("unfortunately terms like 'injury,' 'actual injury,' 'damage' and 'harm' are used in different decisions, and often within the same decision, to represent different concepts.").

[144]*See, e.g.*, Pacific Indem. Co. v. Interstate Fire & Casualty Co., 302 Md. 383, 388, 488 A.2d 486, 488 (1985).

[145]Webster's Ninth New Collegiate Dictionary 323 (1985). The *NEPACCO II* court quoted with approval the Black's Law Dictionary (4th ed. 1951) definition of damage: " 'Damage: Loss, injury or deterioration, caused by the negligence, design or accident of one person to another, in respect of the latter's person or property. The word is to be distinguished from its plural,-"damages"-which means a compensation in money for a loss or damage.' " Continental Ins. Cos. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO II), 811 F.2d 1191, 1189 n.21 (8th Cir. 1987).

suggest to a reasonable insured that sums he was legally obligated to pay for property damage are somehow not within the coverage afforded by a CGL policy. At the very least, in the context of Superfund claims the terms "damages" and "property damage" are susceptible to more than one reasonable meaning and the traditional rules of construction dictate that the doubtful meaning be construed in favor of the insured.

A possible reason for the Fourth Circuit's apparent abandonment of the "reasonable prudent person" standard in *Armco* may rest in the nature of the contract between the insurer and Armco. The court considered it to be "manuscript," that is, some provisions were negotiated with, and specifically written for, the insured.[146] However, the provisions at issue, the duty to indemnify for property damage and the duty to defend, are identical to the language in all standard CGL policies.[147] It is unlikely that Armco or any other commercial insured, sophisticated or not, had enough "bargaining power" to negotiate away the very language which makes the standard policy form *standard*. It follows that the ordinary and common meaning of ambiguous terms should continue to control boiler-plate provisions that are intended, as their name suggests, to provide comprehensive general liability protection.

Both circuits adopted the reasoning of *Aetna Casualty and Surety Co. v. Hanna*[148] to support the finding that an insurer has no duty to defend or indemnify its insured for Superfund cost recovery claims because those claims are equitable in nature.[149] In *Hanna*, the Fifth Circuit held the cost of complying with a mandatory injunction only after damages for noncompliance were assessed was not within the coverage afforded by a CGL policy. But the reasoning of *Hanna*, and other cases[150] holding that there is no coverage for claims seeking mandatory injunctive relief, is too restrictive to encompass the unique statutory liability of Superfund.

Superfund provides the government with a number of tools with which to achieve its objective of hazardous waste clean-up, only one of

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[146]*Armco*, 822 F.2d at 1350. *See also* Brief of Appellee at 14-15, *Armco* (No. 86-3125). The insurer argued that the manuscript policy was replete with legal terms and was the "product of arm's length negotiations between two sophisticated parties. . . ." *Id.*

[147]*See* R. Cushman & C. Stamm, *supra* note 18, at 458, 467.

[148]224 F.2d 499 (5th Cir. 1955).

[149]*See Armco*, 822 F.2d at 1352; *NEPACCO*, 842 F.2d at 986.

[150]Ladd Constr. Co. v. Insurance Co. of North America, 73 Ill. App. 3d 43, ____, 391 N.E.2d 568, 573 (1979) (no coverage for suit seeking injunction to remove debris); Garden Sanctuary, Inc. v. Insurance Co. of North America, 292 So. 2d 75, 77 (Fla. Dist. Ct. App. 1974) (no coverage for equitable claims for restoration of cemetery); Desrochers v. New York Casualty Co., 99 N.H. 129, ____, 106 A.2d 196, 198-99 (1954) (costs of complying with a mandatory injunction do not constitute sums payable "as damages" covered by a liability insurance contract).

which is a mandatory court injunction. Superfund section 107 cost recovery actions, negotiated settlements in the form of administrative orders and consent decrees, and voluntary clean-ups undertaken by responsible parties should be distinguished from the government's authority to seek mandatory court injunctions requiring responsible parties to clean up the site if settlement cannot be reached.[151] In Superfund cost recovery actions, the governments do not seek injunctive relief, but rather a money judgment to reimburse them for the costs incurred in cleaning up a hazardous waste site. A money judgment is "not a distinctly equitable remedy such as an injunction, an equitable lien, or a constructive trust."[152] The government's section 106 authority[153] to compel responsible parties to take remedial action if they refuse to cooperate is substantively distinct from a cost recovery action to pay a money judgment.

The Fourth Circuit also relied on *Haines v. St. Paul Fire & Marine Insurance Co.*[154] for the proposition that claims for equitable relief are not covered by CGL policies.[155] In *Haines*, the Maryland District Court found in favor of the insurer, holding that the insured's potential liability for a restitutionary money judgment ancillary to a SEC claim for injunctive relief was equitable, "not damages in any sense."[156] The *Haines* court, like the district court in *Armco*, analogized to judicial interpretations of the seventh amendment right to a jury trial to support the finding of "no coverage" for claims seeking equitable relief within a CGL policy.[157] Under this theory, if the courts have determined that

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[151]The major elements of the Superfund enforcement process are:

> Identification of responsible parties; Notification of responsible parties of their potential liability for cleaning up the site; Negotiations among EPA and responsible parties to determine if a settlement is possible; Negotiated settlements, which are recorded in administrative orders or court-issued consent decrees; Issuance by EPA of an administrative order or initiation of litigation to obtain a court injunction under Section 106 requiring the responsible party to clean up the site if a settlement has not been reached; and/or, Cleanup of the site with federal funds and action to recover the cost of cleanup later under Section 107.

EPA Could Benefit From Comprehensive Management Information On Superfund Enforcement Actions, reported by General Accounting Office, Dec. 28, 1984 (GAO/RCED-85-3) (*quoted in Superfund I*, *supra* note 1, at 27).

[152]Note, *The Quasi-Contractual Nature of Cost Recovery Actions Under CERCLA*, 5 VA. J. NAT. RESOURCES 85, 142 (1985). The author analyzes the historical basis for restitution and suggests that Superfund cost recovery claims are derived from the common law quasi-contractual action (an action at law) that affords quantum meruit money recovery, recoverable at law as well as in equity.

[153]42 U.S.C. § 9606 (1982 & Supp. IV 1986).

[154]428 F. Supp. 435 (D. Md. 1977).

[155]*Armco*, 822 F.2d at 1352.

[156]428 F. Supp. at 440.

[157]*Id.*; *see* Maryland Casualty Co. v. Armco, Inc., 643 F. Supp. 430, 432 (D. Md. 1986).

defendants in the underlying actions have no right to a jury trial because those claims are equitable in nature, then under an insurance contract the same equitable/legal distinction compels the "no coverage" result. At first glance this seems a logical outcome—Superfund actions cannot be "equitable" for seventh amendment purposes and "legal" for insurance contracts.[158] On closer examination, however, the analogy to the right to a jury trial is not dispositive. The right to a jury trial in the underlying Superfund action has no bearing on the interpretation of a private agreement to insure where the contract is governed not by the dictates of the seventh amendment,[159] but by the intent of the parties,[160] the character and purpose of the contract[161] and the ordinary and popular meaning of its terms.[162]

The general rule followed in most states is that the existence of coverage is controlled by the gravamen of the underlying complaint.[163] The principal does not appear to be abrogated where the insurer is obligated to indemnify for Superfund cost recovery claims. The gravamen of the underlying suit is legal liability for sums expended in cleaning up property contaminated by hazardous wastes generated, transported or disposed of by responsible parties.

Even with the benefit of the Fourth Circuit's reasoning in *Armco*, other federal courts have specifically questioned the value of the equitable relief/legal damages distinction as it applies to contaminated sites. In *Township of Gloucester v. Maryland Casualty Co.*,[164] the township was

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[158]*Armco*, 643 F. Supp. at 435.

[159]Tull v. United States, 107 S. Ct. 1831 (1987) (Petitioner had right to jury trial on the government's civil penalties claim for alleged violations of the Clean Water Act, as amended, 33 U.S.C. §§ 1311, 1344 and 1362(7) (1982 & Supp. IV 1986)).

[160]13 J.A. Appleman, *supra* note 54, at § 7385 (collecting cases which hold that the cardinal rule in construing insurance contracts is to ascertain the intention of the parties).

[161]In construing insurance contracts, courts "examine the character of the contract, its purpose and the facts and circumstances of the parties at the time of execution." Pacific Indem. Co. v. Interstate Fire & Casualty Co., 302 Md. 383, 388, 488 A.2d 486, 488 (1985); "[A Court's function] is to search broadly for the probable common intent of the parties in an effort to find a reasonable meaning in keeping with the expressed general purposes of the policy." Flynn v. Hartford Fire Ins. Co., 146 N.J. Super. 484, 488, 370 A.2d 61, 63 (1977).

[162]*See supra* notes 54-58 and accompanying text.

[163]G. Couch, Couch on Insurance 2d § 51:42 (rev. ed. 1982).

[164]668 F. Supp. 394 (D.N.J. 1987). The court stated it must follow New Jersey law, but observed that "courts in this jurisdiction and outside this jurisdiction have reached opposite conclusions on the coverage question. . . ." *Id.* at 397. It chose to follow *Solvents*, No. L-25610-83 (N.J. Super. Ct. November 17, 1986), *reported in* Hazardous Waste Lit. Rep. (Andrews) 10,453 (February 16, 1987) (*see supra* notes 128-31 and accompanying text) and Broadwell Realty Servs. Inc. v. Fidelity & Casualty Co. of N.Y., 218 N.J. Super. 516, 528 A.2d 76 (1987).

under court order to close and clean up a sanitary landfill that the state claimed had caused and was continuing to cause damage to surrounding ground and surface waters. The township sought a declaratory judgment that its insurers were obligated to indemnify it for those costs under standard CGL policies. The federal district court found the costs of clean-up and closure of the landfill "do constitute 'damages' under the CGL policies at issue,"[165] and adopted the reasoning of *United States Aviex Co. v. Travelers Insurance Co.*[166] In *Centennial Insurance Co. v. Lumbermens Mutual Casualty Co.*,[167] the court also rejected the *Armco* reasoning in favor of those courts following *Aviex*, stating

> Even if the action is preventative or equitable in nature, the costs incurred in cleaning up property damage from toxic contamination are damages within a comprehensive general liability insurance policy. . . . It is in everyone's best interest that toxic waste contamination be prevented in the first place and promptly cleaned up if it is allowed to occur.[168]

In *Aviex*, the Michigan Court of Appeals held that an insurer's obligation to pay under a CGL policy included sums expended by the insured in complying with equitable orders. The court stated:

> If the state were to sue in court to recover in traditional "damages", including the state's costs incurred in cleaning up the contamination, for the injury to groundwater, defendant's obligation to defend against the lawsuit and to pay damages would be clear. It is merely fortuitous from the standpoint of either plaintiff or defendant that the state has chosen to have plaintiff remedy the contamination problem, rather than choosing to incur the costs of cleanup itself and then suing plaintiff to recover these costs. The damage to the natural resources is simply measured in the cost to restore the water to its original state.[169]

The Fourth Circuit found this reasoning wholly unpersuasive.[170] It was particularly critical of the view that cost of restoration is an appropriate measure of damages for injury to property.[171] Like the courts in *New*

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[165] *Gloucester*, 668 F. Supp. at 399-400.

[166] 125 Mich. App. 579, 336 N.W.2d 838 (1983).

[167] 677 F. Supp. 342 (E.D. Pa. 1987).

[168] *Id.* at 350.

[169] 125 Mich. App. at ____, 336 N.W.2d at 842-43 (*quoted in Gloucester*, 668 F. Supp. at 399).

[170] *Armco*, 822 F.2d at 1353.

[171] *Id.*

Castle[172] and *Centennial Insurance*,[173] the *Gloucester* court did not share the Fourth Circuit's narrow view of damages nor its allegiance to the equitable/legal distinction. It held that the *Aviex* view better comported with the reality of toxic waste contamination and clean-up.[174] The Fourth Circuit's criticism notwithstanding, the *Aviex* reasoning not only comports with reality, it recognizes the inequities in a system which would permit insurance coverage for a Superfund suit brought for "damages" to ground water, but would not allow coverage for a suit brought to recover the cost of cleaning up that same ground water. If that were the case, no one with insurance would choose to clean up hazardous wastes in the hope that they would eventually be sued for legal "damages."

Indeed, the *Armco* view does not even seem to comport well with Maryland precedent on the issue of alternative measures of damages. For instance, in *Regal Construction Co. v. West Lanham Hills Citizen's Association*,[175] the Maryland high court held that the cost of restoration is a compensable measure of damages for injury to property. It reaffirmed that the state follows the rule that damages for injury to property may be measured either by loss of value which results from the harm or by the cost of restoration, even if this latter cost "may be greater than the entire value of the property."[176]

The more fundamental reason for the *Armco* decision may rest on either the court's misreading of the facts in the underlying suit or its concern with the breadth and scope of the actions the government is directly empowered to take because of environmental property damage under Superfund. In *United States v. Conservation Chemical Co.*,[177] the government sued the potentially responsible parties under CERCLA section 106 seeking to compel them to implement a comprehensive remedial action program. It also sued the parties under section 107 to obtain reimbursement for its current and future cleanup costs.[178] Yet the *Armco* court apparently did not consider the $2,544,107.40 the government had already incurred in cleaning up contaminated surface and ground water

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[172] 673 F. Supp. 1359 (D. Del. 1987).

[173] 677 F. Supp. 342 (E.D. Pa. 1987).

[174] Township of Gloucester v. Maryland Casualty Co., 668 F. Supp. 394, 399-400 (D.N.J. 1987).

[175] 256 Md. 302, 260 A.2d 82 (1970).

[176] *Id.* at ____, 260 A.2d at 84. *See also NEPACCO*, 842 F.2d at 988 (the legal definition of "damages" under Missouri law includes the cost of restoring real property to its predamaged condition) (Heaney, J., dissenting).

[177] 653 F. Supp. 152 (W.D. Mo. 1986).

[178] 822 F.2d at 1350. The government also brought suit pursuant to the Resource Conservation and Recovery Act of 1976, as amended, 42 U.S.C. §§ 6901-91 (1982 & Supp. IV 1986), but that claim is not involved in the insurance action. *Id.*

and adjacent lands as actual injury to tangible property.[179] In the court's view:

> The case thus presents no instance of harm to human or animal life, but merely the prevention of such harm. Even if some such harm has occurred, the fundamental nature of the government's intervention is the same: the government seeks to prevent or mitigate the occurrences or reoccurrences of hazardous contamination. This action is fundamentally prophylactic, and is not of the sort that Maryland Casualty contracted to cover.[180]

In light of the documented environmental damage in the underlying litigation,[181] the *Armco* reasoning is difficult to justify. CERCLA section 107 liability is not limited to liability for costs associated with preventative measures. It gives the government the necessary authority to sue responsible parties for the costs to remove and dispose of hazardous substances which have caused actual environmental damage.[182] Neither the *Armco* definition of "actual injury," nor its definition of "damages," adopted in *NEPACCO,* seems well suited to the factual reality of Superfund liability, a liability that is imposed because of pervasive and migratory hazardous waste contamination. In an effort to confine insurance coverage to legal rather than equitable claims, the courts have created their own definition of injury which appears to exclude the very real injuries to tangible property caused by environmental contamination.[183]

VI. Conclusion

In resolving Superfund insurance coverage questions, the courts should continue to give consideration to the language of the standard form policies and the traditional rules of insurance contract construction because they provide the foundation for interpreting private insurance

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[179]*See supra* note 89 and accompanying text.

[180]*Armco*, 822 F.2d at 1354.

[181]*See supra* note 89.

[182]CERCLA § 107(a)(3)(A), (B), (C), and (D), as amended, 42 U.S.C. § 9607(a)(3)(A), (B), (C) and (D). SARA added section (D) which provides that health assessments and health effects studies carried out under Section 110 are now recoverable costs. Recoverable costs also include interest accruing from the date of expenditure or the date that the payment is demanded in writing, whichever is later. Further, Section 101 (25) was amended to include the costs for enforcement in the definition of "response."

[183]"It is difficult to imagine a more serious or concrete injury to tangible property than that resulting from hazardous waste contamination." Supplemental Brief for the United States as Amicus Curiae at 15, Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO), 842 F.2d 977, 987 (8th Cir. 1988) (No. 85-1940WM).

agreements. However, the analysis should be coupled with a careful reading of the public policies and purposes associated with both insurance agreements and newly-created statutory liabilities because these policies and purposes provide guideposts for the resolution of these insurance coverage issues.

Superfund is an Act intended to remedy the effects of past disposal practices which only now are perceived to have been improvident and to have caused damage. Its purpose is not to punish responsible parties. It is intended to compensate for the damage caused by past disposal practices as measured by the cost of hazardous waste clean up and removal. The language of the comprehensive general liability policies in effect over the past four decades has provided coverage to insureds for legal liability because of property damage that arises from the day-to-day operations of commercial business. It is neither unreasonable nor against public policy to suggest that those same insurance agreements should encompass the legal liability imposed on insureds for Superfund cost recovery claims.

Madonna F. McGrath